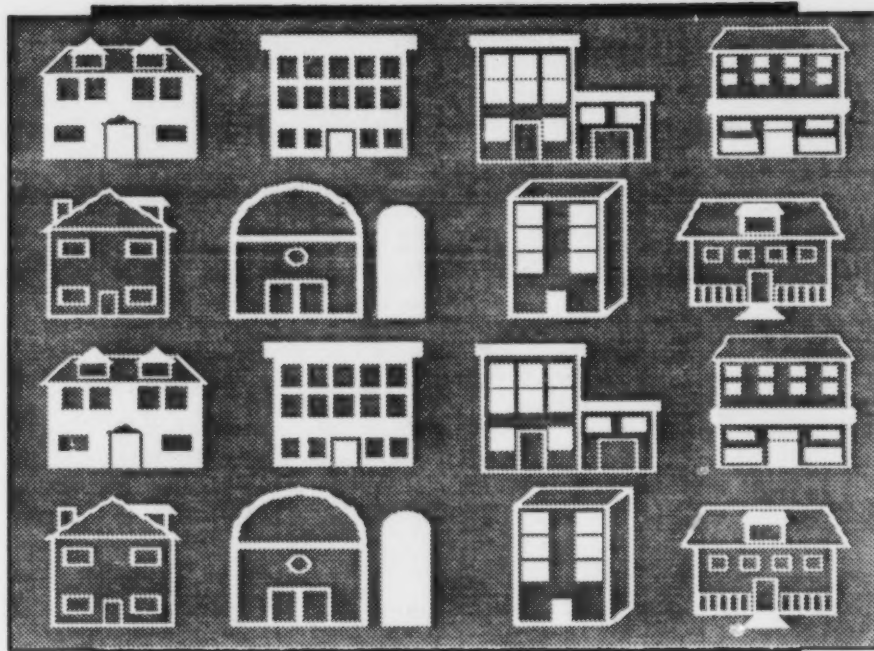




Rental Housing: A Study of Selected Local Markets

Prepared for

Canada Mortgage and Housing Corporation

and

*British Columbia Housing
Management Commission*



Canada Mortgage and Housing Corporation, the federal government's housing agency, and the British Columbia Housing Management Commission, the provincial government's housing agency, jointly funded this research aimed at improving knowledge of the operation of the rental market on the Lower Mainland of British Columbia, and in other selected areas of Canada.

The views expressed in this report are those of the authors and do not represent any official views of Canada Mortgage and Housing Corporation or British Columbia Housing Management Commission.

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**RENTAL HOUSING: A STUDY
OF SELECTED LOCAL MARKETS**

Prepared for

Canada Mortgage and Housing Corporation

and

British Columbia Housing
Management Commission

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EXECUTIVE SUMMARY

This study was commissioned by Canada Mortgage and Housing Corporation and the British Columbia Housing Management Commission to explain the apparent contrast in the performance of several rental markets across Canada with a particular emphasis on the Vancouver and Montreal rental markets.

Both Montreal and Vancouver shared in the gains of the economic expansion and their rental markets are influenced by the same national interest rate and taxation environment, yet there is a question whether their rental markets have performed in a manner consistent with the theoretical operation of markets. In B.C., rent controls ended in 1983 and in the 1988-1990 period the market in Vancouver was characterized by very low vacancy rates and large rent increases. Despite these positive influences, new private rental production was limited. In contrast, rental production in Montreal has been high despite escalating vacancies in both the new and existing stock and the fact that a form of rent control applies in Quebec. The main purpose of the study is to assess whether the Vancouver rental market has failed and what governments can do to improve the operation of the market.

The study also examines the performance of rental markets in London and Winnipeg (where, like Montreal, there was a significant amount of private rental production in the second half of the 1980s in spite of rent controls) and Calgary (where, like Vancouver, there was little rental production despite falling vacancy rates, rising rents and no rent controls). As an aid to explaining the performance of the rental markets in these centres, the study also presents a conceptual framework of the operation of the rental market and an overview of rental market trends in Canada.

Highlights of the study's main findings are presented below.

THE VANCOUVER RENTAL MARKET

Tight Vacancy Rates and Rising Rents in Second Half of 1980s

Rent controls were phased out in B.C. beginning in 1978 and were removed entirely in 1983. The weak economy at the time combined with a substantial new supply of rental and condominium projects kept vacancy rates relatively high and rent increases in check. In the second half of the 1980s, rental markets tightened due to higher levels of demand and rents increased above the rate of inflation.

Little Private Rental Construction But Substantial Increase in Secondary Suites and Rented Houses and Condominiums

Despite the tight rental markets and increasing rents, there was very little new conventional rental construction in Vancouver in the second half of the 1980s. Only about 3,000 new private rental units were built in this period. However, non-

conventional sources of supply (individuals renting houses and condominiums and secondary suites in single-family homes) provided a substantial supply of additional rental housing over this period: there was a net increase of an estimated 28,500 non-conventional rental units in the 1985-1989 period in Vancouver. Non-conventional units comprise an increasingly important part of the Vancouver rental stock.

Economics of Rental Investment Remained Poor Because of Rising Costs

There was little investment in new conventional rental projects in Vancouver in the second half of the 1980s because the economics of rental investment were not attractive. Despite the positive influence of rising rents on rental economics, increasing costs, particularly for land, resulted in a poor investment environment for rental projects. In 1990, the study estimates that a typical new conventional rental unit in Vancouver would generate substantial negative cash flow of over \$2,000 per year in the first year (and still almost \$900 per year in the fifth year), even at 11 percent interest rates. These estimated negative cash flows on new rental projects are well above those on comparable projects in other Canadian centres.

The Booming Condominium Market and a Shortage of Pre-Zoned Land Led to Escalating Land Prices

The condominium market boomed in Vancouver in the second half of the 1980s. There were substantial increases both in the volume and prices of new condominium units built in that period. The substantial increase in the volume of demand for condominium projects combined with the lack of pre-zoned land available for multiple housing developments in Vancouver area municipalities resulted in an escalation in the prices of land available for building. These higher land prices could be supported by the booming condominium market but they further reduced the attractiveness of rental housing investment in Vancouver.

The lack of pre-zoned land in municipalities in the Vancouver area is considered to have been a major factor in the increased prices for land for multiple housing developments and the poor economics of conventional rental investment.

Has the Vancouver Rental Market Failed? No, the Actors in the Market Behaved Rationally

A central question to be answered by this study was whether the rental market in Vancouver had failed because of the apparent lack of supply of new rental housing in the second half of the 1980s. The conclusion reached by this study is that the Vancouver rental market did not fail; the actors in the market behaved rationally, given the available market signals:

- For developers, the economics of rental investment were not attractive. The negative cash flow which would occur throughout the early years of a new rental project offered nowhere near the types of returns available from the development and sale of condominium projects. Therefore, investors concentrated on this market; to do otherwise would have been irrational.

The response to the B.C. Rental Supply Program indicates a high degree of interest in rental investment among Vancouver developers - **if the economics are attractive**. The program attracted approximately 100 applications for a total of 6,500 units; even with the subsidy, most of these projects had a negative cash flow in the early years of the investment.

- For individuals, the potential capital gains from investing in a house or a condominium in a rising real estate market were very attractive, especially with the \$100,000 capital gains tax exemption. Many individuals responded by investing in non-conventional rental housing.
- Other individuals sensed an opportunity to gain income through renting out secondary suites.

The study did, however, identify some areas where government intervention is creating inefficiency in the rental market. The most significant of these is the practice in Vancouver area municipalities of not pre-zoning land; this, plus the difficulties implicit in the lengthy approvals process, results in land shortages and escalating prices, particularly in times of high demand.

The Environment Still is Not Right For New Rental Investment

Several factors point to an improvement in the environment for rental housing investment in Vancouver: the slowdown in the condominium market should reduce the pressure on land and construction costs and also should result in some developers seeking alternative investments such as rental housing. Lower interest rates should also help to improve the economics of rental investment. However, the gap between economic and market rents is still much too large and, with the recent increase in vacancy rates (due to increased supply of condominium units for rent), there will be less pressure for higher rents.

For the longer-term, it is difficult to predict the environment for new rental investment. It seems unlikely that rents could rise sufficiently to bridge the gap between economic and market rents for a considerable period, however, government action could help this process. The key area where government could affect the attractiveness of rental investment is through ensuring there is a sufficient supply of pre-zoned land available for development.

Government Actions Could Assist the Rental Market

The study identified specific actions in three areas by which governments could enhance the supply of rental housing in Vancouver:

- **Ensure an adequate supply of land** - the lack of an adequate supply of land pre-zoned for multiple housing was identified as the single most important factor behind the lack of new conventional rental construction in Vancouver in the second half of the 1980s. High demand from condominium developments bid up land prices and crowded out rental developments. To overcome this problem in the future, municipalities should prepare realistic projections of the demand for housing and ensure that there is a more than adequate supply of pre-zoned land to meet this demand.
- **Facilitate the creation of secondary suites** - the expansion of the supply of secondary suites in Vancouver has occurred in spite of municipal regulations which attempt to restrict their creation. Legalizing secondary suites without occupancy restrictions would encourage the creation of more of these units which are appropriate and affordable for smaller households of limited means.
- **Encourage small investors** - small investors in rental houses and condominiums and secondary suites have been responsible for most of the additional rental housing created in Vancouver in the past several years. There are also opportunities to encourage small investors in creating new conventional rental housing - as has occurred in Montreal. Initiatives which could enhance the presence of small investors include the creation of new zoning categories for small apartments buildings and triplexes, allowing convertible space to be included or roughed-in in new single-family houses and reducing the time required and complexity of obtaining necessary approvals.

The study also concluded that the limited subsidies available for rental housing from government should be directed at assisting needy tenants, not stimulating private sector investment. Such subsidies are very costly and provide only a temporary increase in supply - they do not address the underlying problem of the poor economics of rental investment. In addition, on-off government programs create a climate of uncertainty in the market.

THE RENTAL MARKETS IN MONTREAL, CALGARY, LONDON AND WINNIPEG

The performance of the rental market in each of these centres was also examined in this study, though in less detail than for Vancouver.

Rental Investment Attractive to Individuals in Montreal

In Montreal, there was substantial investment in rental housing throughout the second half of the 1980s. In the early part of the period, rental investment was stimulated by the widespread belief that it was a low risk investment vehicle with sufficient long-run potential to withstand short-run deficits, combined with a general fever of speculation in real estate that accompanied the economic upturn and declines in mortgage interest rates. This continued in the late 1980s in spite of evidence of softening markets because investors took the long-term view and other development opportunities (e.g. condominium developments) were not as attractive.

The relatively low land and construction costs and the popularity of smaller buildings in Montreal meant that the small investor could get involved with relatively small amounts of equity. The attraction of the small investor to rental housing was further enhanced by the introduction of the \$100,000 capital gains tax exemption. The presence of many small investors, each acting more or less independently, kept rental investment in Montreal at relatively high levels.

Although the Montreal rental market is subject to a form of rent control, the system is not as restrictive as in many other jurisdictions, and does not appear to impact negatively on investors' expectations of potential capital appreciation.

London Rental Investors Expected Attractive Returns Despite Rent Controls

In London, there was a substantial volume of new rental construction in the second half of the 1980s despite the fact that investors would have known that the buildings would be subject to rent control. An analysis of the economics of the new rental buildings indicates that investors expected an attractive rate of return on these investments; however, with the significant oversupply in the London market, it is likely that the actual returns on these buildings are well below expectations.

The promotion of syndicated rental buildings as tax shelters to higher income individuals was responsible for much of the activity in the London market - lender policies which allowed the financing of these buildings based on their values as condominiums (rather than their rent stream) also facilitated this investment. The perception of London as a relatively stable market prompted some of the investor interest in syndications in the City. A number of developers also built rental housing for their own portfolios - offsetting income from other properties with both operating and depreciation losses from the new projects.

The fact there was no shortage of land and the lack of a substantial alternative market for multiple housing land as condominiums were important in encouraging London developers to build rental housing - either for syndication to other investors or for their own portfolio.

Government Programs and Tax Shelters Promoted Rental Investment in Winnipeg

In Winnipeg, there was a substantial volume of new rental construction in the second half of the 1980s. Government programs and the promotion of rental buildings as tax shelters encouraged much of the private rental construction. As a result of the high volumes of construction, the Winnipeg rental market is currently oversupplied and most of the new projects are suffering from high vacancy rates and lower than expected rents.

Key factors in the increase in the supply of rental housing in Winnipeg were the government programs which stimulated new rental construction. Tax shelters and some developers building for their own portfolio were also important contributors to the supply of new rental buildings. An abundance of available land and a lack of alternative attractive investments in condominiums also were important factors in steering developers towards new rental housing projects - either for their own portfolio or for syndication as tax shelters. Some developers appear to have built projects simply to utilize their non-producing land assets, in a long-term investment. The fact that new rental projects in Manitoba are not subject to rent controls for five years was also a factor in the new rental investment.

Calgary Developers Wary of Rental Investment, Economics Could be Attractive Soon

In Calgary, there was little rental construction in the second half of the 1980s despite tightening rental markets and rising rents. After the severe downturn in the Alberta economy in the mid 1980s, rental markets suffered very high vacancy rates and declining rents. It took several years before rents again reached the range in which they were potentially attractive to investors. However, investors were hesitant to get involved in what they perceived to be a high risk investment vehicle - they remembered what happened to real estate values when the market collapsed.

An analysis of the economics of rental investment in Calgary in 1990 indicated that increasing rents combined with stable costs had resulted in an improvement in the attractiveness of rental investment to the point where investors might have been expected to build new projects. Discussions with developers indicated significant interest, however, the increase in interest rates to 13 percent in 1990 made most of this potential investment unattractive.

With the increase in vacancy rates to over 4 percent in early 1991, it is unlikely that significant numbers of new rental projects will be built in the short-term. However, with the recent declines in interest rates, it seems likely that new rental investment will occur in Calgary when vacancy rates moderate.

SOMMAIRE

La Société canadienne d'hypothèques et de logement et la British Columbia Housing Management Commission ont commandé la présente étude en vue d'expliquer la divergence apparente entre les performances de plusieurs marchés locatifs au Canada, en particulier les marchés de Vancouver et de Montréal.

Montréal et Vancouver ont bénéficié tous les deux de la croissance économique et leurs marchés locatifs sont soumis aux mêmes taux d'intérêt et au même contexte fiscal qui prévalent à l'échelle nationale; toutefois, on se demande si la performance de ces marchés est restée conforme au fonctionnement théorique des marchés. En Colombie-Britannique, on a mis fin au contrôle des loyers en 1983 et, pendant la période de 1988 à 1990, le marché de Vancouver a été caractérisé par un taux d'inoccupation très faible et par des augmentations de loyers importantes. Malgré ces conditions favorables, la production de nouveaux logements locatifs privés est restée limitée. Montréal, par contre, a connu une production considérable de logements locatifs en dépit de l'escalade du taux d'inoccupation dans les secteurs des logements neufs et existants et malgré l'application au Québec d'une certaine forme de contrôle des loyers. L'étude vise essentiellement à déterminer si le marché locatif de Vancouver a échoué et quel rôle le gouvernement peut jouer pour améliorer l'état du marché.

L'étude porte également sur la performance des marchés locatifs de London et de Winnipeg (où, comme à Montréal, il y a eu une production élevée de logements locatifs privés pendant la seconde moitié des années 1980, en dépit du contrôle des loyers), de même que pour Calgary (où, comme à Vancouver, la production de logements locatifs a été faible malgré la baisse des taux d'inoccupation, la hausse des loyers et l'absence de contrôle. Dans le but d'expliquer la performance des marchés locatifs dans ces centres, l'étude présente aussi un cadre conceptuel pour le fonctionnement du marché locatif et un aperçu des tendances de ce marché au Canada.

Voici les faits saillants de l'étude :

LE MARCHÉ LOCATIF DE VANCOUVER

Resserrement des taux d'inoccupation et majoration des loyers pendant la seconde moitié des années 1980

Le contrôle des loyers a été graduellement supprimé en Colombie-Britannique à compter de 1978 et complètement éliminé en 1983. La faiblesse de l'économie, de même qu'une offre importante de nouveaux projets locatifs et en copropriété, maintenaient à l'époque les taux d'inoccupation relativement élevés et freinaient l'augmentation des loyer. Pendant la deuxième moitié des années 1980, les marchés locatifs se sont resserrés en raison

de l'accroissement de la demande et les loyers ont augmenté au delà du taux d'inflation.

Peu de construction de logements locatifs privés, mais accroissement important du nombre d'appartements aménagés dans des maisons individuelles, de maisons et de logements en copropriété loués

Malgré le resserrement des marchés locatifs et l'augmentation des loyers, on a construit très peu de nouveaux logements locatifs traditionnels à Vancouver pendant la deuxième moitié des années 1980. Seulement environ 3 000 nouveaux logements privés ont été construits pendant cette période. Toutefois, les sources non traditionnelles (location par des particuliers de maisons, de logements en copropriété et d'appartements aménagés dans des maisons individuelles) ont engendré une offre importante de logements locatifs additionnels pendant cette période : il y a eu un accroissement net d'environ 28 500 logements locatifs non traditionnels à Vancouver entre 1985 et 1989. Ces logements représentent une part de plus en plus importante du stock de logements locatifs de Vancouver.

Les investissements sur le marché locatif sont demeurés peu intéressants en raison de coûts à la hausse

On a peu investi dans les projets de nouveaux logements locatifs traditionnels à Vancouver dans la seconde moitié des années 1980 parce que ce type d'investissement était peu intéressant sur le plan économique. Malgré les effets positifs de la hausse des loyers sur l'aspect économique des logements locatifs, l'accroissement des coûts, notamment celui des terrains, a créé un piètre contexte pour les investissements dans les projets locatifs. Selon la présente étude, un logement locatif neuf traditionnel engendrerait en 1990 à Vancouver un mouvement négatif annuel de l'encaisse de plus de 2 000 dollars pour la première année (et de près de 900 \$ encore pendant la cinquième année), même avec un taux d'intérêt de 11 p. 100. Les mouvements négatifs de l'encaisse prévus pour les nouveaux projets locatifs sont de beaucoup supérieurs à ceux enregistrés dans les autres centres canadiens pour des projets semblables.

Le marché florissant des logements en copropriété et la pénurie de terrains dont le zonage a été établi ont mené à l'escalade du prix des terrains

Le marché des logements en copropriété a été prospère à Vancouver pendant la deuxième moitié des années 1980. Il y a eu des augmentations importantes du volume et du prix des logements en copropriété construits pendant cette période. L'accroissement important de la demande d'ensembles en copropriété, combiné avec le manque de terrains dont le zonage a été établi pour des

logements collectifs dans les municipalités de la région de Vancouver, ont entraîné une escalade du prix des terrains disponibles à des fins de construction. Le prix élevé des terrains pouvait être absorbé par le marché florissant des logements en copropriété, mais il rendait encore moins intéressant l'investissement dans les logements locatifs à Vancouver.

Il semble que le manque de terrains avec zonage établi dans les municipalités de la région de Vancouver ait été un facteur majeur entraînant la hausse du prix des terrains destinés aux logements collectifs et réduisant l'intérêt sur le plan économique des investissements dans le marché locatif traditionnel.

Le marché locatif de Vancouver a-t-il échoué?

Non, les intervenants se sont comportés de façon rationnelle

La présente étude devait d'abord et avant tout chercher à savoir si le marché locatif de Vancouver avait échoué en raison de la pénurie apparente de logements locatifs neufs enregistrée au cours de la seconde moitié des années 1980. Selon les conclusions de l'étude, le marché locatif de Vancouver n'a pas échoué; les intervenants du marché se sont comportés de façon rationnelle, compte tenu des indices du marché :

- * Pour les promoteurs immobiliers, les aspects économiques des investissements sur le marché locatif n'étaient pas intéressants. Le mouvement négatif de l'encaisse, qui se serait produit pendant les premières années d'un nouvel ensemble résidentiel, était loin d'engendrer les mêmes bénéfices que le développement et la vente d'ensembles de logements en copropriété. Par conséquent, les investisseurs se sont concentrés sur ce dernier marché; toute autre option aurait été irrationnelle.

La réponse reçue par le Rental Supply Program de la Colombie-Britannique indique que les promoteurs de Vancouver s'intéressent beaucoup aux investissements dans les logements locatifs, **si les aspects économiques sont intéressants**. Le programme a fait l'objet d'environ 100 demandes, pour un total de 6 500 logements. Même avec la subvention, la majorité de ces ensembles d'habitation ont enregistré un mouvement négatif de l'encaisse pendant les premières années.

- * Pour les particuliers, les gains potentiels en capital générés par l'investissement dans une maison ou un logement en copropriété, dans le contexte d'un marché immobilier en pleine croissance, étaient très intéressants, compte tenu surtout de l'exemption fiscale sur les gains en capital de 100 000 dollars. De nombreuses personnes ont réagi en investissant dans des logements locatifs non traditionnels.

- * D'autres ont vu une occasion d'augmenter leurs revenus en louant des appartements aménagés dans des maisons individuelles.

L'étude a cependant relevé certains secteurs où l'intervention du gouvernement créait un problème d'efficacité sur le marché locatif. Le fait que des municipalités de la région de Vancouver n'établissent pas le zonage des terrains à l'avance en est l'exemple le plus important. Ce fait, de même que les difficultés inhérentes au long processus d'approbation, entraîne une pénurie de terrains et une escalade des prix, particulièrement dans des périodes où la demande est forte.

Le contexte économique ne se prête pas encore aux investissements sur le marché des logements locatifs neufs

Plusieurs facteurs laissent croire à une amélioration du contexte économique pour l'investissement sur le marché locatif à Vancouver : le fléchissement du marché des logements en copropriété devrait réduire la pression exercée sur le coût des terrains et de la construction et certains promoteurs chercheront à faire des investissements dans d'autres secteurs tel que le logement locatif. Les faibles taux d'intérêt devraient aussi aider à l'amélioration des aspects économiques des investissements sur le marché locatif. Toutefois, l'écart entre les loyers économiques et du marché sont encore trop importants et, compte tenu de l'augmentation récente du taux d'inoccupation (causée par l'offre accrue de logements en copropriété qui sont à louer), les pressions à la hausse sur les loyers devraient être atténuées.

Il est difficile de prévoir le contexte à long terme pour les investissements dans les logements locatifs neufs. Il semble improbable que les loyers augmentent suffisamment pour combler l'écart entre les loyers économiques et du marché avant un certain temps, mais des mesures gouvernementales pourraient accélérer le processus. Le principal moyen pour le gouvernement de rendre plus intéressants les investissements sur le marché locatif serait de s'assurer qu'il y a suffisamment de terrains dont le zonage a été établi de disponibles à des fins d'aménagement.

Des mesures gouvernementales pourraient aider le marché locatif

Voici trois mesures que pourraient prendre les gouvernements pour accroître l'offre de logements locatifs à Vancouver :

- * S'assurer d'une offre suffisante de terrains - On a conclu que le manque de terrains dont le zonage a été établi pour des logements collectifs était le seul facteur réellement important expliquant le peu d'intérêt pour la construction de logements locatifs traditionnels à Vancouver pendant la

deuxième moitié des années 1980. La forte demande de logements en copropriété a fait monter le prix des terrains et a évincé les promoteurs du marché locatif. Dans le but de surmonter ce type de problème à l'avenir, les municipalités devraient préparer des prévisions réalistes des demandes de logement et s'assurer qu'il y a une abondance de terrains dont le zonage a été établi pour répondre à cette demande.

- * **Faciliter la création d'appartements aménagés dans des maisons individuelles** - Il y a eu augmentation de l'offre d'appartements aménagés dans des résidences principales à Vancouver, en dépit des arrêtés municipaux visant à les restreindre. Le fait de légaliser ce type de logement sans restriction d'occupation encouragerait la création d'un plus grand nombre de ces appartements, qui sont appropriés et abordables pour les petits ménages à revenus modestes.
- * **Encourager les petits investisseurs** - Les petits investisseurs louant des maisons, des logements en copropriété et des appartements aménagés dans des maisons sont responsables de la majorité des logements locatifs additionnels créés à Vancouver au cours des dernières années. On pourrait aussi inciter les petits investisseurs à créer de nouveaux logements locatifs traditionnels, comme à Montréal. Certaines initiatives pourraient attirer la participation de petits investisseurs, telles que la création de nouvelles catégories de zonage pour les petits immeubles d'appartements et les triplex, l'autorisation de prévoir ou d'aménager un espace pouvant être converti en appartement dans les nouvelles maisons individuelles, et la réduction du délai et des complications liés à l'obtention des approbations nécessaires.

Selon les conclusions de l'étude, les quelques subventions du gouvernement qui sont disponibles pour les logements locatifs devraient être accordées aux locataires dans le besoin et non pas aux investisseurs privés. Ces subventions sont très coûteuses et ne font qu'accroître temporairement l'offre; elles ne visent pas le problème sous-jacent, soit le peu d'intérêt sur le plan économique des investissements dans le marché locatif. De plus, l'apparition et la disparition de programmes gouvernementaux entretiennent un climat d'incertitude sur le marché.

LES MARCHÉS LOCATIFS DE MONTRÉAL, CALGARY, LONDON ET WINNIPEG

Notre étude a également considéré la performance des marchés locatifs dans chacun de ces centres, mais de façon moins détaillée que pour Vancouver.

Des investissements intéressants pour les particuliers sur le marché locatif de Montréal

Montréal a connu des investissements importants dans les logements locatifs pendant toute la seconde moitié des années 1980. Au début de la période, l'investissement était stimulé par la croyance répandue qu'il s'agissait d'un investissement à faible risque qui avait suffisamment de potentiel à long terme pour résister aux déficits à court terme, de même que par la fièvre générale de spéculation immobilière qui accompagnait le redressement de l'économie et la baisse des taux d'intérêt hypothécaire. Cette tendance s'est poursuivie à la fin des années 1980, en dépit de l'affaiblissement évident des marchés, parce que les investisseurs adoptaient une vision à long terme et que les autres options de développement (par ex. les logements en copropriété) n'étaient pas aussi intéressantes.

Les coûts relativement faibles des terrains et de la construction, ainsi que la popularité des petits immeubles à Montréal, signifiaient qu'on pouvait investir avec un avoir propre relativement peu élevé. Le logement locatif est devenu encore plus intéressant pour le petit investisseur par suite de l'entrée en vigueur de l'exemption fiscale sur les gains en capital de 100 000 dollars. L'existence de nombreux petits investisseurs, plus ou moins indépendants, a maintenu les investissements sur le marché locatif à des niveaux relativement élevés.

Même si le marché locatif de Montréal est assujéti à une certaine forme de contrôle des loyers, le système n'est pas aussi restrictif que dans de nombreuses autres régions et ne semble pas avoir de répercussions négatives sur la plus-value en capital escomptée par les investisseurs.

Les investisseurs du marché locatif de London s'attendaient à des bénéfices intéressants malgré le contrôle des loyers

A London, on a enregistré un volume élevé de construction de logements locatifs neufs pendant la deuxième moitié des années 1980, même si les investisseurs n'étaient pas sans savoir que les immeubles seraient assujettis au contrôle des loyers. Selon l'analyse des aspects économiques relatifs aux nouveaux immeubles locatifs, les investisseurs s'attendaient à des bénéfices intéressants pour ces investissements; toutefois, compte tenu d'une offre excédentaire importante sur le marché de London, il est probable que les bénéfices réels pour ces immeubles soient en deçà de leurs attentes.

La promotion d'immeubles locatifs exploités en syndicats pour servir d'abri fiscal aux personnes à revenu élevé compte pour une grande partie de l'activité du marché de London. Les politiques des prêteurs qui permettaient le financement de ces immeubles en se basant sur leur valeur comme logements en copropriété (plutôt

que sur les revenus en loyers) ont également facilité ces investissements. Une partie de l'intérêt manifesté par les syndicats de la ville s'explique par le fait que London était considéré comme un marché relativement stable. Un certain nombre de promoteurs immobiliers ont également construit des logements locatifs pour leurs propres portefeuilles, contrebalançant les revenus provenant d'autres propriétés par les pertes d'exploitation et de dépréciation des nouveaux projets.

Le fait qu'il n'y ait pas eu de pénurie de terrain et qu'il n'ait existé aucun autre marché important pour les terrains destinés aux logements collectifs, comme les logements en copropriété, ont été des facteurs importants ayant incité les promoteurs de London à construire des logements locatifs, soit pour l'exploitation en syndicats par d'autres investisseurs ou pour leur propre portefeuille.

Les programmes gouvernementaux et les abris fiscaux ont encouragé les investissements sur le marché locatif de Winnipeg

A Winnipeg, on a constaté un volume important de construction de nouveaux logements locatifs pendant la seconde moitié des années 1980. Les programmes gouvernementaux et la promotion d'immeubles locatifs en guise d'abris fiscaux expliquent une grande partie de la construction de logements locatifs privés. Étant donné ces volumes élevés de construction, l'offre sur le marché locatif de Winnipeg est actuellement excédentaire et la majorité des nouveaux ensembles d'habitation enregistrent des taux d'inoccupation élevés et des loyers inférieurs à ce qui était prévu.

Les programmes gouvernementaux, qui ont stimulé la construction de nouveaux logements locatifs, constituent les principaux facteurs ayant entraîné l'augmentation de l'offre de logements locatifs à Winnipeg. La recherche d'abris fiscaux et le fait que certains promoteurs ont fait construire pour leurs propres portefeuilles ont également contribué de manière considérable à l'offre de nouveaux immeubles locatifs. L'abondance de terrains et l'absence de possibilités d'investissements intéressantes dans le secteur des logements en copropriété représentent aussi des facteurs importants ayant dirigé les promoteurs vers de nouveaux projets de logements locatifs, que ce soit pour leur propre portefeuille ou pour l'exploitation en syndicats comme abri fiscal. Certains promoteurs semblent avoir construit des ensembles résidentiels uniquement dans le but d'utiliser les terrains non productifs qu'ils possédaient déjà, comme investissement à long terme. Le fait que les nouveaux ensembles locatifs au Manitoba ne sont pas assujettis au contrôle des loyers pendant cinq ans a également été un facteur déterminant.

Les promoteurs de Calgary hésitent à investir sur le marché locatif, mais les aspects économiques pourraient bientôt être intéressants

Calgary a enregistré il y a eu peu de construction de logements locatifs pendant la deuxième moitié des années 1980, en dépit du resserrement des marchés locatifs et de l'augmentation des loyers. Après la régression marquée de l'économie de l'Alberta au milieu des années 1980, les marchés locatifs ont connu des taux d'inoccupation très élevés et des loyers en déclin. Il a fallu attendre plusieurs années avant que les loyers atteignent des niveaux susceptibles d'attirer les investisseurs. Ces derniers ont quand même hésité à utiliser ce qu'ils croyaient être un véhicule d'investissement à risque élevé, car ils se rappelaient ce qui était arrivé aux valeurs immobilières quand le marché s'est effondré.

Selon l'analyse des aspects économiques des investissements sur le marché locatif de Calgary en 1990, la hausse des loyers et la stabilité des coûts ont rendu ce type d'investissement plus intéressant; on se serait donc attendu à ce que les investisseurs construisent de nouveaux ensembles résidentiels. À la lumière de discussions avec des investisseurs, il semble que ces derniers manifestaient beaucoup d'intérêt pour la construction d'ensembles de logements, mais que l'augmentation des taux d'intérêt à 13 p. 100 en 1990 leur a fait changer d'idée.

Étant donné l'augmentation du taux d'inoccupation à plus de 4 p. 100 au début de 1991, il est peu probable qu'on construise un nombre important de nouveaux ensembles locatifs à court terme. Compte tenu de la baisse récente des taux d'intérêt, il semble toutefois que les investissements sur le marché locatif de Calgary pourraient s'accroître quand les taux d'inoccupation seront plus convenables.

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CHAPTER 1

INTRODUCTION

Canada Mortgage and Housing Corporation (CMHC) and the British Columbia Housing Management Commission (BCHMC) commissioned Clayton Research Associates, assisted by Jules Hurtubise, Économiste and City Spaces Consulting, to prepare this study on the operation of rental housing markets in Canada.

1.1 STUDY PURPOSE

The main purpose of the study is to explain the contrasting performance of the rental markets in Vancouver and Montreal, to assess whether the Vancouver rental market has failed and, if so, to ascertain what governments can do to restore the market.

To paraphrase the terms of reference for the study: both Montreal and Vancouver shared in the gains of the economic expansion and their rental markets are influenced by the same national interest rate and taxation environment, yet their rental markets do not appear to have performed in a manner consistent with the theoretical operation of markets. In B.C., rent controls ended in 1983 and in the 1988-1990 period the market in Vancouver was characterized by very low vacancy rates and large rent increases. Despite these positive influences, new private rental production was limited. In contrast, rental production in Montreal has been high despite escalating vacancies in both the new and existing rental stock and the fact that a form of rent control applies in Quebec.

1.2 STUDY APPROACH

The study concentrates mainly on the supply side of the rental market and the effects of various factors on the willingness and ability of the suppliers of rental housing to respond to market signals. In particular, factors such as the regulatory environment, government policies and programs, the types and motivations of the investors in rental housing, the economics of rental construction, the demand for rental housing and the performance of the condominium market (through its impact on the supply of land for multiple housing) all influence the volume and nature of the supply of rental housing in any market.

Taking Vancouver and Montreal as the two main case study markets, and supplementing the analysis with a less in-depth examination of trends in three other major Canadian centres with contrasting rental market trends (Calgary, London, and Winnipeg), the study examines the main influences on the supply response in rental housing markets in Canada.

The majority of the analysis in the study was undertaken in the second half of 1990 and the discussion generally reflects the situation at that time. Since then, interest

rates have eased and vacancy rates have risen in most markets; however, these changes do not affect the contrasting performance of rental markets in the period to the end of 1990 - the purpose of this report.

1.3 REPORT STRUCTURE

The study is divided into the following eight chapters:

- **Chapter 1 - Introduction:** this chapter, which provides an overview of the report content and structure.
- **Chapter 2 - Conceptual Framework of the Operation of the Rental Market:** a theoretical examination of the operation of the rental market and its key actors. The analysis concentrates mainly on the supply side of the rental market though demand is briefly reviewed as well. The framework examines the role of demand and supply, who invests in rental housing, factors which influence the investment decision and how they vary in their impact on different types of actors.
- **Chapter 3 - Overview of Rental Market Trends in Canada:** a review of the main trends in rental housing in Canada over the past two decades. The levels and composition of production are examined at the national level, as well as the changes in government and lenders' policies and real estate market trends which have impacted the supply of rental housing. This chapter concludes with a brief review of overall rental market trends in the five centres (Calgary, London, Winnipeg, Montreal and Vancouver) selected for more intensive examination in this study and the reasons for their selection.
- **Chapter 4 - The Rental Markets in Calgary, London, and Winnipeg:** an overview of rental market trends in these three centres with an analysis of the reasons behind these trends. Calgary, London and Winnipeg were selected for analysis because they do not appear to conform to the theory of rental market operation: Calgary has no rent controls, but has had little new rental construction in recent years, London and Winnipeg have rent controls but have had a great deal of new rental construction with the result that these markets are oversupplied. The analysis of trends in these three markets is intended to provide a basis for comparing (in Chapter 7) the situations in Vancouver and Montreal with experiences elsewhere in Canada.
- **Chapter 5 - The Montreal Rental Market:** an examination of the operation of the rental housing market in Montreal. The emphasis is on the supply side of the rental market. The chapter includes a review of recent trends in the Montreal rental market, a description and analysis of the structure of the rental supply industry and a description of the demand and

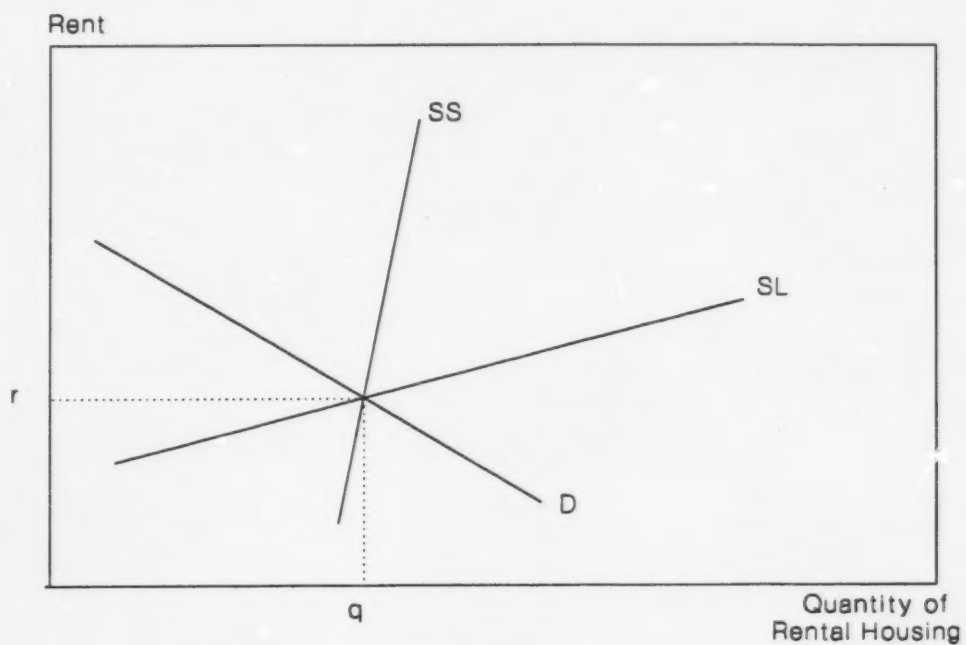
supply factors in the Montreal rental market which can explain the apparent contrast between its operation and the operation of markets in other parts of Canada. The analysis is intended to identify the reasons why construction escalated in the 1985-1987 period despite a rent controlled environment, and why it has continued at relatively high levels despite increasingly adverse market conditions.

- **Chapter 6 - The Vancouver Rental Market:** an examination of the operation of the rental housing market in Vancouver. As with the Montreal analysis, the emphasis is on the supply side of the rental market in Vancouver. The chapter includes a review of recent rental market trends, a description and analysis of the structure of the rental supply industry and a description of the demand and supply factors in the Vancouver rental market which can explain the fact that little new rental construction is occurring despite the shortage of rental accommodation and rising rents. The analysis is intended to identify the reasons why there appears to be relatively little interest in new rental investment when the market seems right for such investment.
- **Chapter 7 - Overall Review of Reasons for Different Trends in the Five Rental Markets:** an analysis of the differences in the rental investment environment in Calgary, London, Winnipeg, Montreal and Vancouver which can explain the apparent differences in the supply responses in these centres to the signals in the market. This chapter draws heavily on the reviews of the Montreal and Vancouver rental markets as well as the separate analysis of the rental markets in the other three centres.
- **Chapter 8 - The Future of the Vancouver Rental Market:** answers to a series of questions regarding the operation of the rental market in Vancouver which were posed in the terms of reference for this study. The main questions posed were:
 - Has the rental housing market failed in Vancouver? and if so,
 - What can governments do to restore the market?

The answers to these two questions are provided through a review and analysis of the main issues involved in assessing whether the Vancouver rental market is likely to move to a balance between supply and demand in the foreseeable future and what will be necessary to achieve this balance.

The study also contains a separate volume with two appendices which provide the detailed results of surveys of rental investors in Montreal and Vancouver which were undertaken as part of this study.

EXHIBIT 2-1
SIMPLIFIED RENTAL MARKET OPERATION



CHAPTER 2

CONCEPTUAL FRAMEWORK OF THE OPERATION OF THE RENTAL MARKET

This chapter provides a theoretical examination of the operation of the rental market and its main actors. The analysis concentrates mainly on the supply side of the rental market though demand factors are briefly reviewed as well. The framework examines the role of demand and supply, who invests in rental housing and factors which influence the investment decision and how they vary in their impact on different actors.

The final section deals with the concept of market failure and establishes criteria by which judgements can be made about whether rental markets have failed. The presentation throughout this chapter is strictly theoretical. Discussion of the application of this conceptual framework to Canada as a whole and the five centres under study is provided in Chapters 3-7 of the study.

2.1 OVERVIEW OF RENTAL MARKET OPERATION

This section provides an overview of how theory suggests rental markets might be expected to operate.

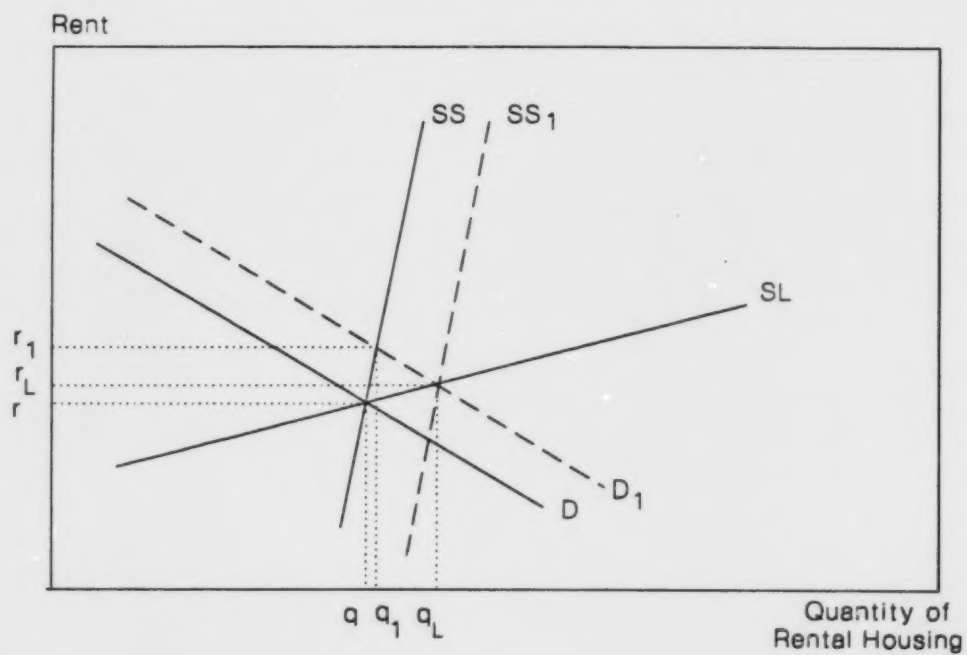
2.1.1 A Simple Theoretical Model of the Rental Market

Rental markets are complicated structures subject to a vast array of actors and influences. However, for analysis, rental markets in their simplest form can be considered to operate as any other commodity market in that the quantity of rental housing forthcoming and its price (i.e. rents) are determined by the forces of supply and demand (assuming no government intervention).

The demand for rental accommodation is inversely related to the level of rents - other things being equal, the higher the rent, the lower the quantity demanded. This inverse relationship produces a normal, downward sloping demand curve for rental accommodation, as shown by D in Exhibit 2-1.

For rental supply, on the other hand, other things being equal, the higher the rent, the greater the amount of rental accommodation that will be produced by private sector firms. This relationship results in an upward sloping supply curve, also shown in Exhibit 2-1. In the short-run, rental housing is relatively inelastic (SS), due to the

EXHIBIT 2-2
ADJUSTMENT TO DEMAND SHOCK



long lead times in supplying some forms of new housing.¹ Over the longer-term, rental supply is more elastic (SL).

The intersection of the supply and demand curves results in an equilibrium "price" i.e. rent (r), and quantity (q).

"Shocks" to either the demand or supply curve will disturb this equilibrium.² For example, assume a large influx of migrants to an area. This can be expected to cause a rightward shift in the demand curve (to some location such as D_1 in Exhibit 2-2). At rent r , quantity demanded will exceed quantity supplied and a tightening in vacancy rates (below those necessary for normal operation) will result. As vacancy rates decline, rents can be expected to increase, to some level such as r_1 . In response to this price increase, adjustments in supply that are possible in the short-run will occur and quantity supplied will increase to q_1 . Over the longer-term, the higher prices will attract more suppliers of rental housing, such that the short-run supply curve will shift to SS_1 . The longer-run equilibrium will therefore occur at rent level r_L and quantity q_L .

2.1.2 Unfortunately, Actual Rental Markets Are Much More Complicated

Rental markets are, in fact, much more complex than the above theoretical analysis would imply. In the real world, there are a myriad of factors which complicate an analysis of the rental market and can hinder the movement of supply and demand toward equilibrium.³ Among some of the more important complicating factors are the following:

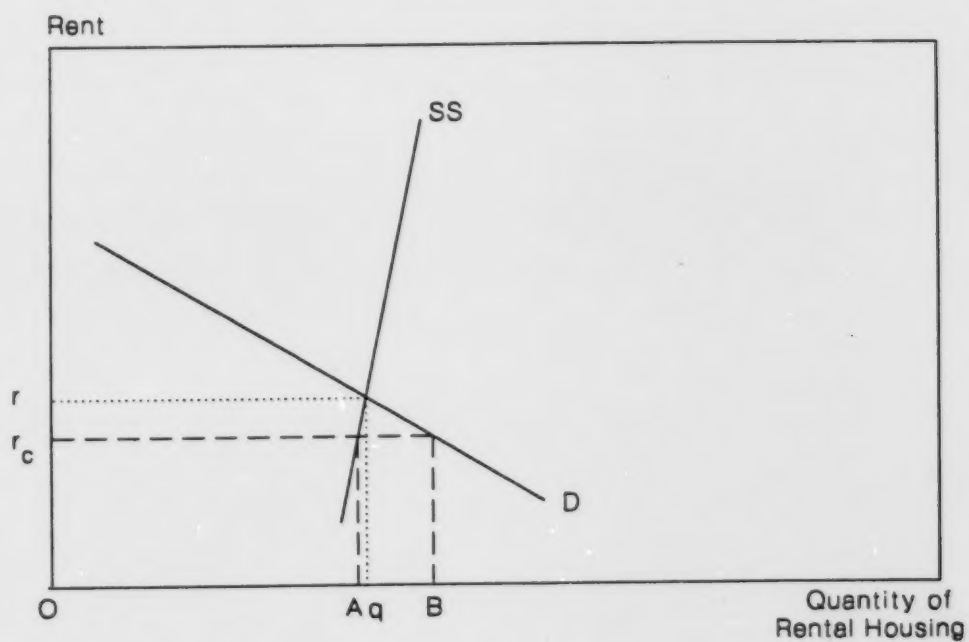
- **Rental housing is not a standard commodity** - rental housing is much more heterogeneous than most commodities such as, for example, bread or television sets, in that there is a wide range of diversity within the supply (such as with respect to location, amenities, etc.), making it more difficult to compare prices and attributes of units.
- **Demand is for the services provided, not the unit itself** - "buyers" are not purchasing the commodity itself but rather the services that the unit provides. Furthermore, the services provided by any two units within the large stock of rental housing need not be the same.

1 It is not, however, totally inelastic, as often portrayed. Although new construction responds slowly to changes in market signals, non-conventional sources of supply (such as secondary suites and renting out houses and condominiums) can be more quickly forthcoming.

2 The factors influencing supply of and demand for rental housing will be addressed in more detail in Sections 2.2 and 2.3.

3 This section draws in part upon work in John R. Miron, *Demand Sensitivity to Price Change in the Rental Housing Market*, prepared for CMHC, 1982, Chapter 2.

EXHIBIT 2-3
IMPACT OF RENT CONTROL



- **Costs of moving and vacancies** - there are costs to renters associated with moving from one unit to another, such that rental demand manifested in the marketplace at any point in time may not reflect their current underlying preferences. At the same time there are costs to the ownership of rental housing associated with vacancies (loss of revenue, advertising and upgrading costs, etc.) which may cause underpricing of units.
- **Government intervention** - governments can affect either demand or supply in rental markets through various programs and policies. A topical example is the imposition of rent controls. Rent controls interfere in the free operation of the rental market in that they impose a maximum rent level, rather than allowing a market which clears through adjustments in price levels as a result of the interplay of the forces of supply and demand.

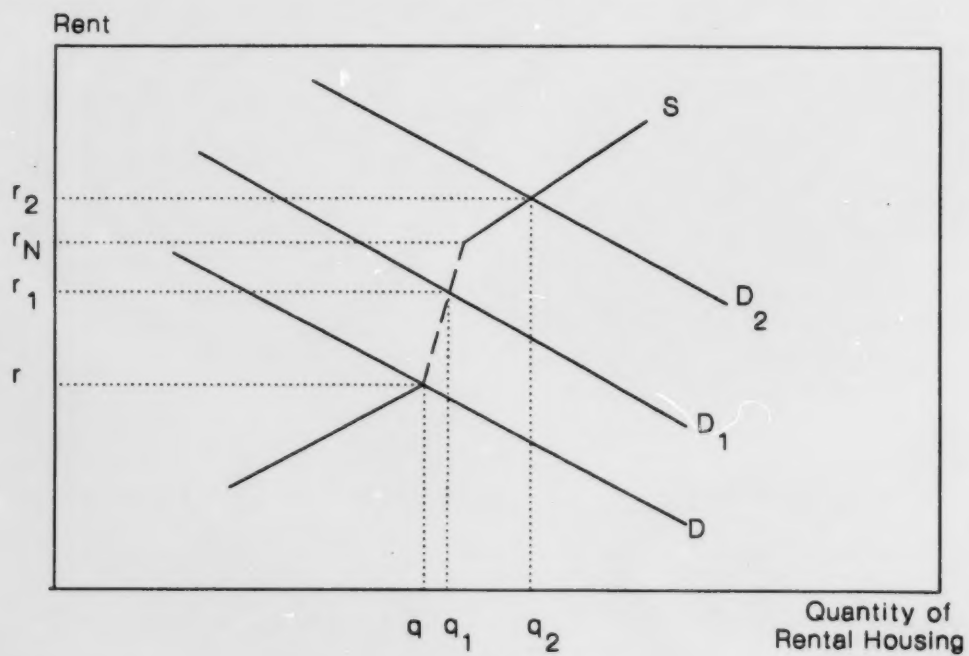
As illustrated in Exhibit 2-3, if rents are artificially suppressed below the equilibrium price dictated by supply and demand forces (at some level such as r_c), the result is a shortfall in supply (i.e. the quantity demanded at the lower price (OB), exceeds the quantity supplied (OA) by AB). If the market were freely operating, theory suggests that the excess demand would put pressure on rents to rise, to r . Since this cannot occur with rent controls, the excess demand will persist. There will be no equilibrium price and quantity at which the market "clears" - therefore, shortages will occur.⁴

Government intervention may also take the form of incentives or subsidies which lower the cost of producing rental housing. If incentives are used which favour one type of supplier over another or to the extent that government directly competes in the market by either providing rental housing or leasing units for occupancy by selected tenants, the operation of the market is further complicated.

- **Interdependence with ownership market** - as rental and ownership housing are substitutes, the two markets cannot be viewed in total isolation. Changes in rents and housing prices will impact on both supply and demand in the other markets.
- **Interdependence with other real estate markets** - factors in other real estate markets may impact on the supply of rental housing. For example, a strong condominium market might provide increased pressure on the price of land and construction inputs for new rental housing.
- **Supply lags** - changes in supply respond slowly to changes in demand, given the long lead times (up to several years) between conceptual plan and completed construction on large rental projects.

4 This, of course, is a simplified analysis - in reality there is not one single rent level and rent control schemes vary widely in their particulars.

EXHIBIT 2-4
KINKED SUPPLY CURVE



The supply lags help explain why a change in vacancy rates in a particular time period may not result in a change in the level of rental construction for a year or two. Consider a decline in vacancy rates:

- 1) the decline is expected to lead to increases in rents;
- 2) the increased rents will stimulate interest in supplying new rental accommodation and plans for new buildings will be formulated;
- 3) the pre-construction arrangements are made (e.g. land purchase, approvals process, contracting etc.);
- 4) construction finally begins and the start is recorded.

The process is further complicated by the fact that between steps (1) and (4) other forces may have come into play. For example, interest rates may have increased before construction began and a decision could be made not to proceed.

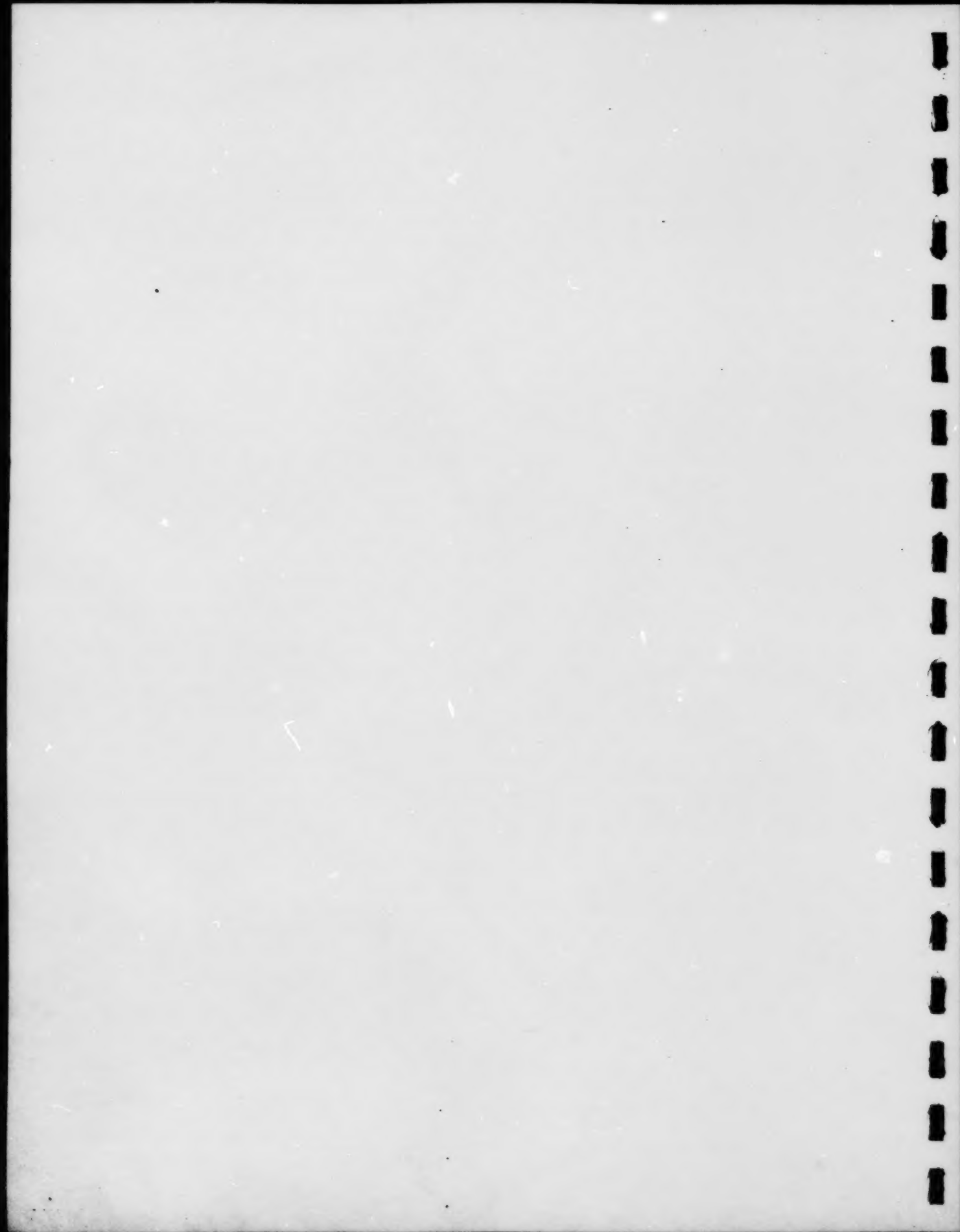
- **Supply is fragmented** - rental housing services can be supplied from three sources: (1) the existing stock of rental units; (2) newly constructed supply; and (3) creation of additional rental units from within the existing housing stock.⁵ Given changes in construction and land costs over time and the small cost of creating units in the existing stock, the costs of supplying units at any point in time are unlikely to be uniform among different types of suppliers.

The complication to the simple model of the rental market shown in Exhibit 2-1 presented by the fragmented nature of rental supply is illustrated in Exhibit 2-4. Here the supply curve is shown as "kinked". Suppliers of existing (conventional and non-conventional) rental housing can only supply up to quantity q , regardless of higher rents; at q , their supply curve becomes vertical. Suppliers of newly constructed conventional rental housing will supply nothing until rents reach r_N (perhaps due to high construction costs) - their supply curve therefore commences at that point.⁶ Non-conventional supply could account for increases in quantity supplied for rents between r and r_N as well as some supply above r_N . The kinked supply curve results from the aggregation of these underlying supply curves.

Demand, represented by D , intersects with the supply curve at q and r - with q being able to be satisfied from within the existing stock. A shift in demand to some position such as D_1 causes an increase in rents to r_1 , but little additional new supply is forthcoming - the increase in rents may be

5 Units created within the existing stock are referred to in this study as non-conventional rental housing - this includes houses, units in owner-occupied condominium buildings and secondary suites (such as basement apartments and self-contained flats) in single-family dwellings. Conventional rental housing refers to purpose-built rental housing - generally rental apartment buildings and rental townhouse complexes.

6 R_N represents the "economic rent" - the rent required to cover all expenses and provide a reasonable rate of return to rental investors.



sufficient to induce additional non-conventional supply (hence, the supply curve is not totally vertical in this region), but is not sufficient to attract new conventional rental construction. Demand would have to shift more substantially such as to D_2 , and rents rise to above r_N , for new construction to be forthcoming. In this case, for rents below r_N , new rental construction is not economically attractive to the producers of new conventional rental housing.

- **Supply is affected by markets for factors of production** - as for many markets, the supply side of the rental market is characterized by a market between the producers of rental housing and the suppliers of the inputs required to produce rental housing. These include:
 - the market between producers and landowners;
 - the market between producers and sub-contractors and suppliers;
 - the market between producers and lenders.

Also, if the project is to be sold by the producer upon completion, the market between producers and purchasers or investors in the rental buildings must be considered. These are all affected by trends which are subject to influences outside of the rental market.

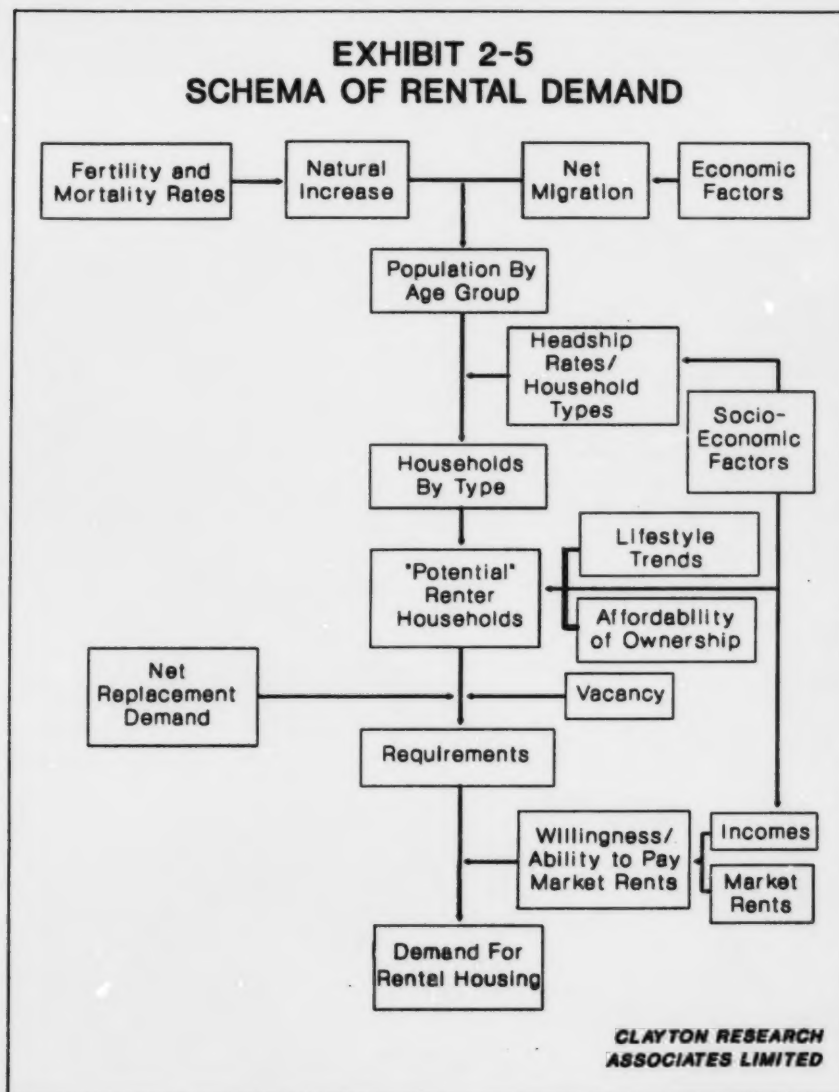
While the complicating factors outlined in this section can hinder the operation of the rental market, and certainly they complicate an **analysis** of the market, there is, nonetheless, little doubt that the rental market is a **market**, however imperfect.⁷ There are buyers and sellers who purchase or supply the services of rental housing for agreed prices. The purpose of this study is to assess whether the imperfections in the rental market prevent it from behaving in the manner generally described in theory.

2.2 RENTAL HOUSING DEMAND

This section briefly reviews the factors which influence the demand for rental housing. Since the main emphasis in this study is on the supply side of the rental market, the discussion here only briefly summarizes the main factors involved on the demand side of the market.

7 Readers interested in a more thorough discussion of the theoretical operation (and complications) of the rental market are referred to George Fallis, *Housing Economics* (Butterworths: Toronto, 1985), Chapter 1-4 and Hal Varian, *Intermediate Microeconomics: A Modern Approach* (W.W. Norton: New York, 1987), Chapter 1.

EXHIBIT 2-5 SCHEMA OF RENTAL DEMAND



2.2.1 Rental Demand is Influenced by Demographic and Socio-Economic Factors

The schema on the opposite page (Exhibit 2-5) provides an overview of the factors which ultimately determine the demand for rental housing. The demand for rental housing is based on a consideration not only of the underlying requirements for rental housing but, as well, the proportion of renters willing and able to pay prevailing market rents.

Rental housing requirements measure the amount of rental housing necessary to accommodate the number of renter households which could be expected to be formed based solely on demographic factors. Demand for rental housing goes one step further, in that it also incorporates consideration of a household's ability and willingness to enter the rental market, given prevailing rents.

The key factor underlying rental housing requirements is population by age group. For any given geographic area, the age composition of the population results from births, the normal aging of the population and the level and age composition of both deaths and net migration.

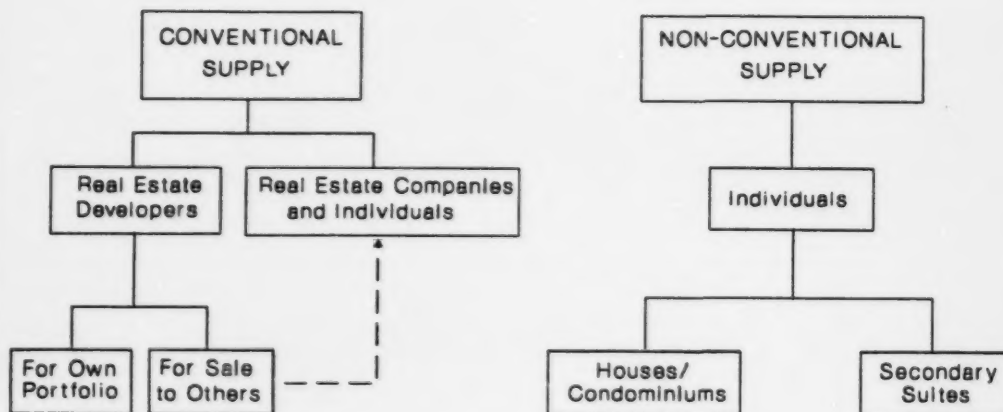
Household headship rates (the proportion of the population in a given age group who are heads of households) and propensities to form different types of households (family/non-family) are very age specific. Headship rates are generally low among people in the younger age groups, increase through the middle age groups then decline for the older population. Young households tend generally to have a high proportion of non-families; as they age, family households are more prevalent though, with deaths of spouses, the incidence of non-family households increases in the older age groups. Therefore, the age composition of the population is an important factor in determining households by type.

Tenure preferences vary substantially by both age of head and household type; as well, lifestyle trends and the relative costs of renting versus homeownership in any time period are key factors in determining the number of "potential" renter households. These "potential" households, along with requirements for net replacement demand (to account for units lost from the stock through fire and demolitions and those gained through conversions, etc.) and an allowance for vacancies to facilitate choice, are the determinants of rental housing requirements.

Whether these requirements will be translated into effective demand for rental housing however depends on households' willingness and ability to pay prevailing market rents for units in a given location. Ability to pay market rents (i.e. affordability of rental housing) in turn is determined by the level of market rents relative to renter incomes and the share of this income renters are willing (or able) to devote to rent. Ability to participate in rental markets, given initial willingness, may be enhanced by government initiatives to provide units at below market rents.

This demand for rental housing is expressed as a demand for an almost infinite variety of housing types, sizes, conditions and locations - all with varying rents and

**EXHIBIT 2-6
INVESTORS IN RENTAL HOUSING**



CLAYTON RESEARCH ASSOCIATES LIMITED

degrees of interchangeability. Changes in the level of demand within various rental submarkets will, theoretically, stimulate a response on the supply side of the market. In the case of an increase in demand (the more usual situation), additional units will need to be created or shortages will occur.

It is the mechanisms behind the creation (or non-creation) of these units, the **supply** side of the market, which is the main interest of this study. The analysis recognizes, however, that it is the inter-relationship between supply and demand that ultimately impacts the level of rental construction.

2.3 RENTAL HOUSING SUPPLY

This section discusses the suppliers of private rental housing, their criteria for deciding to invest in rental housing and the factors that influence these criteria and decisions. Publicly-initiated rental supply is not considered since it is not generally subject to market considerations. The discussion here is in general theoretical terms; the Canadian experience with respect to the factors that influence supply is dealt with in Chapter 3.

2.3.1 Who Invests in Rental Housing?

For this analysis, it is useful to disaggregate rental supply into two main types:

- **Conventional supply** - rental apartment buildings and townhouse complexes built for the specific purpose of rental to tenants. This includes rental projects which have been registered as condominium.
- **Non-conventional supply** - rental units in dwellings originally built as part of the ownership stock but instead are rented by their owners to tenants. These mainly include houses, units in owner-occupied condominium projects and secondary suites (such as basement apartments and self-contained flats) created in single-family dwellings.

There are three major types of rental housing investors:

- **Developers** - these are companies primarily engaged in the business of real estate development. Developers undertake the actual construction of conventional rental buildings. They may retain the property as part of their own portfolio, or sell to other investors either outright or perhaps by syndicating the building as a tax shelter. Developers may range from large corporations to individuals building small projects. Smaller developers generally operate only within a local or regional market, but some larger developers operate nationally or even internationally.

EXHIBIT 2-7

SAMPLE PRO FORMA OF RENTAL INVESTMENT (\$ per unit)

Project Financing:

Development Cost (Land, Construction and Soft Costs)	72,000
Mortgage	54,000
Equity	18,000

Annual Revenues and Costs

	Year 1	Year 10*
Revenues		
Rental Income	8,400	13,030
Vacancy (5%)	(420)	(650)
Other Income	360	560
Gross Income	8,340	12,940
Operating Costs (Maintenance and Property Taxes)	2,700	4,190
Net Operating Income	5,640	8,750
Mortgage Payments**		
Principal	325	1,010
Interest	6,820	6,135
Total	7,145	7,145
Net Income	(1,505)	1,605

* Income and operating costs assumed to increase at the rate of 5% per year.

** Mortgage rate of 13% over a 25 year term.

Source: Clayton Research Associates.

- **Companies and individuals investing in conventional rental housing** - these comprise companies or individuals who purchase rental property from a developer or another investor; they are not involved in the development stage. They include individuals investing in syndicated rental buildings as a tax shelter. The scope of this group may vary widely in terms of ownership (foreign versus domestic), structure (corporation, partnership, co-ownership, sole ownership) and size (large, medium, small).
- **Individuals investing in non-conventional rental housing** - this group is comprised mainly of individuals who rent out condominiums, houses, secondary suites or other types of non-conventional rental housing. This type of investor is generally small (usually owning only one or two units).

2.3.2 Why Do They Invest in Rental Housing?

There are a multitude of factors which combine to influence the overall decision of someone to invest in something. However, these can be distilled into one prime financial motivation: the risk-adjusted rate of return on investment. In theory, rental investment, like any investment, takes place because the investor perceives the investment as providing the greatest rate of return (over the period of ownership) relative to the risk-adjusted rate of return on alternative investments.⁸

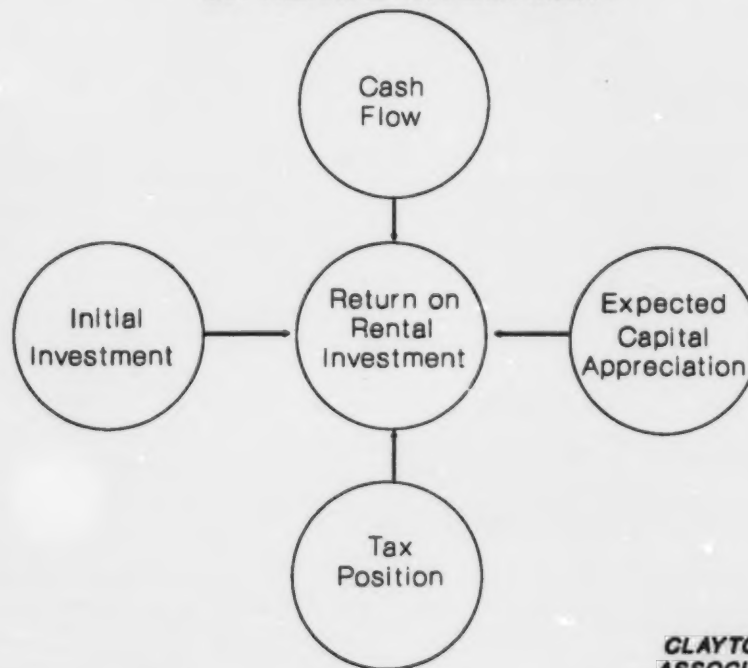
To help in assessing the rate of return on an investment in rental property, an investor needs to consider the capital costs and financing that would be involved as well as the ongoing costs and revenues from the property. This generally requires a pro forma analysis - a simplified pro forma analysis of a rental investment is presented in Exhibit 2-7 for illustrative purposes.

Briefly, the main items involved in a pro forma analysis of rental investment are:

- **Project financing:** the total costs of the project, the size of the mortgage and the amount of equity which the investor must provide.
- **Revenues:** income from rental revenue and other sources (laundry, parking, etc.) less an allowance for vacancies.
- **Operating Costs:** expenses involved in maintenance and repairs as well as property taxes.
- **Net operating income:** the difference between revenue and operating costs.
- **Mortgage Payments:** the principal and interest payments on the mortgage.

8 The concept of risk-adjustment also includes risk management through portfolio diversification.

EXHIBIT 2-8
DETERMINANTS OF RATE OF RETURN
ON RENTAL INVESTMENT



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- **Net income:** the net cash flow from the property before tax considerations.

These are shown in the sample pro forma in Exhibit 2-7, both for the initial year and for 10 years in the future to illustrate the fact that cash flow from a property can change significantly over time. The sample project initially generates a negative cash flow but this improves over time. By year 10 (assuming 5 percent inflation in rents and operating costs), the project is generating a return on initial equity (not counting contributions which had to be made to offset negative cash flow or repayments of mortgage principal) of 9 percent (before taxes are considered).

This type of pro forma provides much of the information required to assess the rate of return on a rental property and is used extensively in the analysis of rental market trends in the five major centres presented in later chapters of this study.

2.3.3 What are the Key Issues Involved in Assessing the Rate of Return on Investing in Rental Housing?

For an investor in rental housing, there are three main issues which must be considered in determining the overall rate of return in rental housing:

- Before tax cash flow (or net income);
- Tax position; and
- Capital appreciation.

These, plus the size of the initial investment and the terms on which it is made, are key to the assessment of the attractiveness of rental investment.⁹ Each of these is discussed in more detail below:

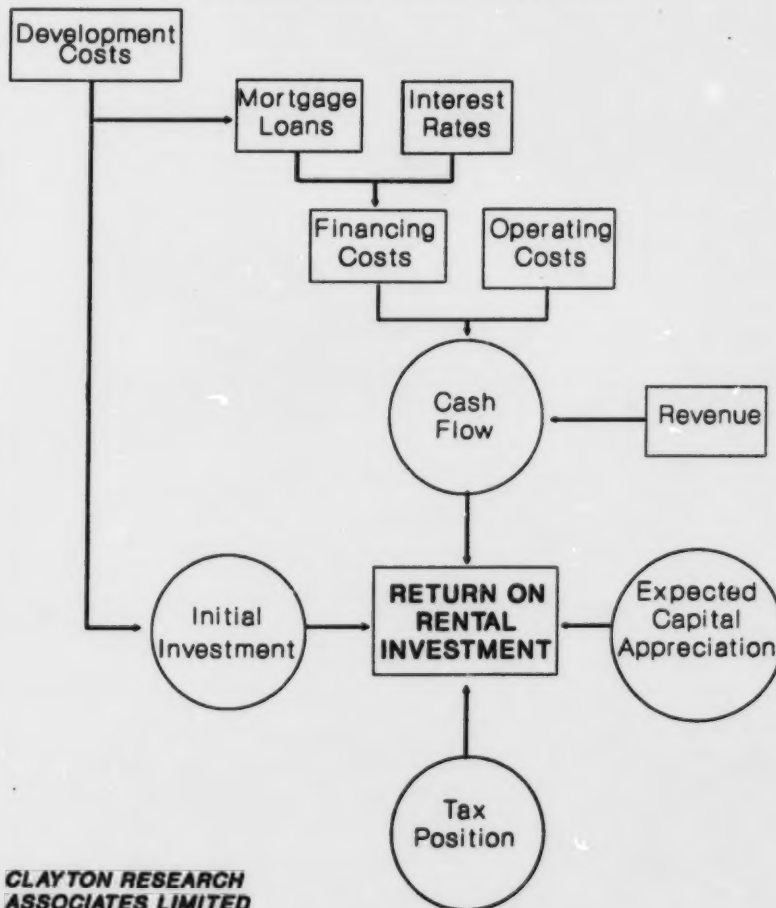
- **Before Tax Cash Flow** - often called net income - is the difference between all on-going revenues generated by the investment less all expenses related to it. As illustrated in the pro forma in Exhibit 2-7, sources of revenue include rents (the major component), as well as any additional revenues from such items as parking or laundry. Expenses include mortgage and interest payments (which will depend on development costs and the amount of the initial investment as well as interest rates), maintenance costs and property taxes.

Investors need to consider not only the initial cash flow position of the investment, but the expected future cash flow. They therefore require a future scenario for the factors impacting cash flow and how they might change from the initial situation.

- **Tax Position** - investment in rental housing may enjoy preferential tax treatment which can enhance the overall return on the investment. Therefore, although initial cash flow may be negative, rental investment

9 See W. Paul O'Mara and Cecil E. Sears, *Rental Housing* (Urban Land Institute: 1984), p. 20.

**EXHIBIT 2-9
FACTORS IMPACTING RETURN
ON RENTAL INVESTMENT**



may still be attractive if the losses can be written off against other income for tax purposes.

This aspect can be very complex and varies for different types of investors. It is the subject of considerable discussion later in this chapter and in Chapter 3.

- **Capital Appreciation** - expected net capital gains are very important when determining longer-term returns on a major investment such as rental housing. Again, if substantial future capital gains are expected (e.g. either by real estate values rising with inflation, or by the prospect of converting a rental building for sale as condominiums), short-term negative cash flows may be acceptable. However, the future cash flow scenario will itself be a critical consideration in this regard as rental properties are generally valued in terms of current and expected future cash flow before debt service (i.e., net operating income).¹⁰

Since rental properties are generally financed by a large mortgage, investors can obtain significant leverage on their investment in an inflationary environment as the value of their mortgage loan declines (in real terms) and both the real and money value of their equity increases. This can, of course, work against investors in a deflationary environment.

In addition to cash flow, tax position and expected capital appreciation, the size of the initial investment is a factor in the determination of overall return. The size of the initial investment will be influenced both by lender requirements and the investor's preferred leverage position.

Exhibit 2-9 illustrates how these considerations interact to determine the rate of return plus the impact which the factors considered in the sample pro forma presented in Exhibit 2-7 have on each. To the extent that development costs must be covered by either the initial investment or the mortgage, the size of these are dependent both on the level of development costs and the relative shares of each. The size and terms of the loan and interest rates determine the financing costs. The combination of financing and operating costs plus revenue determine before tax cash flow. Expected capital appreciation is dependent on expectations of future revenues (and operating costs) as well as expectations of future changes in property values. Tax position is independent of any of these factors but, along with cash flow, expected capital appreciation and the size of the initial investment, is a critical component of the assessment of the overall return on the investment.

These considerations all need to be taken into account in evaluating a particular rental investment but they can have varying degrees of importance for different types

10 Net operating income determines the value of the property as rental housing; in some markets, the potential of a particular site for alternate uses may enhance the underlying value of the investment.

of rental investors.¹¹ Real estate developers and larger companies, for example, are generally in a better position than smaller investors to undertake investments which have initial negative cash flows, as they could have alternate sources of income, and may also be able to take advantage of tax benefits which may not be available to other investors. They also have the option of syndicating the project.¹² However, there generally must be prospects for future improvement to cash flow if longer term capital gains are to be realized. Preferential tax treatment may also assist companies and individuals weather a cash flow deficit depending on the tax provisions available at a given point in time.

For the individual investing in non-conventional rental housing, particularly a secondary suite, however, positive cash flow is generally critical. Individuals tend to be more concerned with short-term returns and will generally not have the means to weather large long-term negative cash flows; nor may they be able to take advantage of preferential tax provisions which may be available to companies. For some individual investors, however, capital appreciation may be a critical factor as well, particularly for those renting out condominiums and houses as an interim measure while awaiting an improved market, or those who feel the existence of a secondary suite will add substantially to dwelling value.

Not all investors, of course, will undertake an explicit, detailed analysis of each component of overall return; smaller investors in particular are less likely to undertake a "sophisticated" analysis. However, there will generally be some broad investigation of the key elements.

Cash flow, tax position and expected capital appreciation determine the expected overall financial rate of return (considering both short-term and long-term factors) on a given rental investment, however, they are not in themselves enough to determine whether the investment will be made. Once an investor has determined what the short- and long-term returns will be, a comparison must then be made with the expected returns on alternative types of investment. This analysis takes account not only of calculated rates of return, but also (implicitly or explicitly) on rates adjusted to incorporate the varying degrees of risk associated with different types of investments. It also needs to recognize that risk can be reduced by diversifying an investment portfolio among several types of investments.

For the economically "rational" investor, this comparison of rates of return on rental and alternative investments will be sufficient to determine whether or not investment will occur. However, not all investors are necessarily "rational" in the economic sense of the term, nor do they necessarily actually undertake the detailed calculations required to compare alternative investments. Other, non-financial, factors may also

11 See Wayne Clendenning, *The Viability of Rental Construction, the Effect of Rent Controls, and Strategies for a Smooth Return to A Fully Viable Rental Sector*, Chapter 3, prepared for CMHC in 1980, for a discussion of investment criteria for different types of investors.

12 Smaller investors in syndicated projects can also benefit from tax advantages - this is discussed in Chapter 3.

enter into the investment decision. For example, force of habit (e.g., previous rental investors continuing in this sector even though an analysis would indicate they could potentially do better with some other type of investment with comparable risks) may result in a decision to invest in rental housing because that is the area where the investor is more "comfortable" since the environment is more familiar.

2.3.4 What Factors Influence Cash Flow, Tax Position and Capital Appreciation on Rental Investment?

The previous section indicated that investors generally base their decisions to invest in rental housing on the rate of return expected on the initial investment (after considering expected current and future cash flow, tax position and expected capital appreciation) vis-à-vis the rate of return (adjusted for perceived risk differentials) on alternative investments. This section examines the factors which influence cash flow, tax treatment and capital appreciation.

All of these factors which influence the cash flow, tax position and capital appreciation will, in turn, influence the rate of return on a given investment in rental property - and ultimately determine whether the investment is attractive.

2.3.4.1 Factors influencing cash flow

There are a plethora of factors which influence cash flow on a rental project but these can be condensed into two main groups: factors which influence rental expenses and factors which influence rental income.

Factors influencing rental expenses

- **Financing costs:** as illustrated in the pro forma presented in Exhibit 2-7, the largest component of rental expenses is the mortgage principal and interest payment. This in turn is dependent on:
 - development costs: construction (materials and labour) and land costs (influenced by location);
 - the share of development costs which are financed with mortgages;
 - interest rates (both for interim financing and long-term financing);
 - the amortization period on the mortgage; and
 - any incentives given by government at the development stage.

For investors buying from developers and small investors renting out houses and condominiums, "development" costs are generally mainly the purchase price for the units. For the homeowner with a secondary suite, the costs associated with the conversion of living space to the suite would be included; for buyers who need the income to help finance the purchase of a home, a share of the purchase price of the home could also be included.



- **Operating expenses:** items such as property taxes, utilities (if paid by landlord), leasing costs, maintenance costs, etc. These types of operating expenses have a similar impact on all types of rental investors.

Factors influencing rental income

- **Rental income:** a new rental unit's rent is largely determined by the rents prevailing in the market for existing comparable accommodation. Market rents do not necessarily reflect the **economic rents** for new buildings (i.e. the rent required to cover all expenses and provide a reasonable rate of return to the investor).

To the extent that rent controls are in existence, market rents may be well below the level that would be achieved by the interaction of unconstrained supply and demand forces.

- **Other income:** income from other sources such as laundry and parking. Lost income from vacant units is also considered. These sources are generally a small component of total rental income.

Over time, the cash flow from a rental property can generally be expected to increase as revenues rise with inflation while expenses, dominated by mortgage payments which generally remain steady over time (assuming no major change in interest rates), increase at a slower rate.

2.3.4.2 Factors influencing tax position

The major factors which determine tax position are the following:

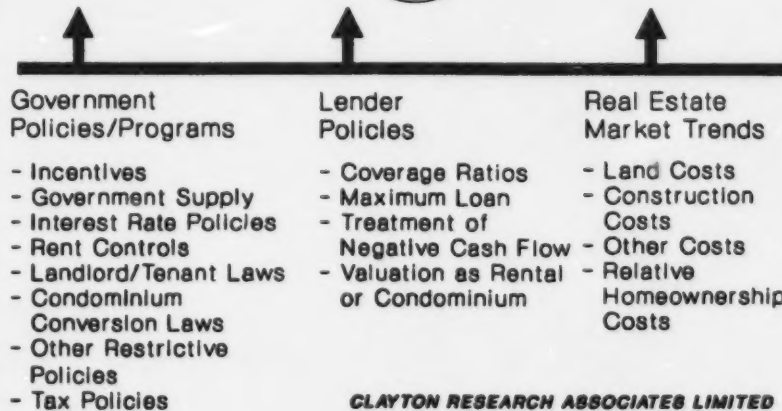
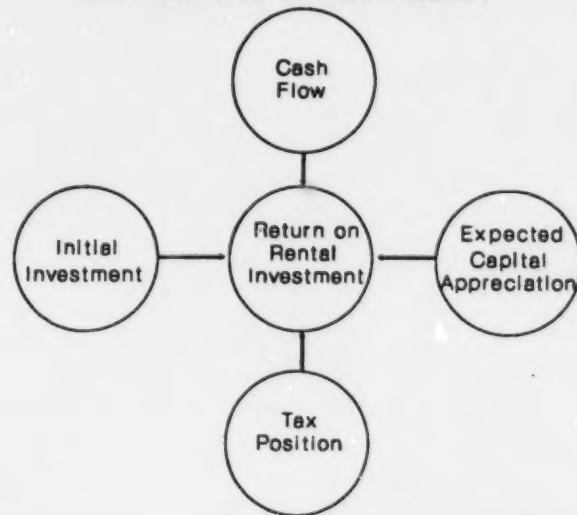
- **Current and expected government tax policies:** the tax treatment of rental investment may change through time, so the policy in effect at the point of decision as well as future known or expected changes to the policy must be considered.

Of particular importance here is the ability to deduct expenses of various types from the income from the property, the ability to apply losses from the property to shelter income from other sources, and (more appropriately dealt with in the next section on capital appreciation) the treatment of capital gains when the property is sold.

- **Type of rental investor:** all types of investors are not necessarily in the same tax position with respect to rental investment.

Past and current policies with respect to the tax treatment of income and losses from rental housing in Canada are reviewed in Chapter 3.

EXHIBIT 2-10 **IMPACT OF SUPPLY FACTORS** **ON RENTAL INVESTMENT**



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2.3.4.3 Factors influencing capital appreciation

The major considerations in determining expected capital appreciation include:

- **Expected inflation:** the expected rate of inflation and the expected gain in real estate values relative to general inflation are important considerations.
- **Expected future rental income:** rental properties are generally valued in relation to their net operating income - revenues less operating expenses and before mortgage payments. To the extent that growth in revenues exceeds the growth in operating expenses (which is generally the case in an inflationary environment), the value of the building can be expected to increase over time.
- **Potential for sale in alternative uses:** if government policies allow the conversion of rental buildings to condominiums (even with restrictions), there may be potential for capital appreciation by selling off individual units in a rental building to homeowners and investors. Or, redevelopment of the site to build condominiums or a non-residential building may provide a higher value than as a rental property. The potential for capital appreciation in this manner will be influenced by the market for other types of real estate as well as the costs of conversion or demolition and rebuilding.

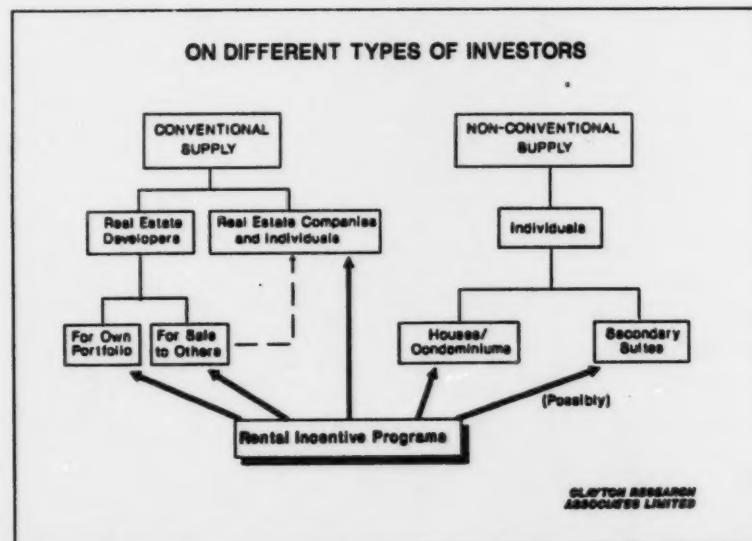
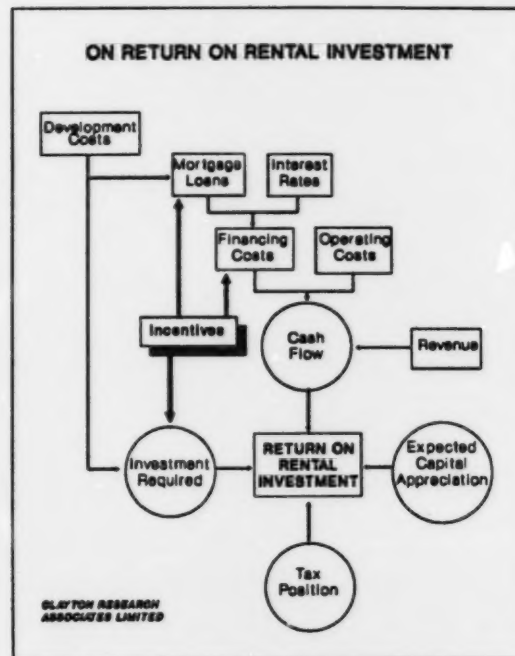
Investors examining the potential for capital appreciation should also be cognizant of the tax provisions with respect to capital gains of various types.

2.3.5 How Do Government Programs, Lender Policies and Real Estate Market Trends Affect the Rate of Return on Rental Investment?

It is clear from the foregoing analysis that the suppliers of rental housing operate within a market which is greatly influenced by much more than simply the demand for rental housing and competition from other rental housing suppliers. Government policies and programs, the policies of mortgage lenders and trends in the real estate market all influence the attractiveness (the relative rate of return) on new rental investment by influencing either the size of the initial investment required, current and future cash flow, the investor's tax position, prospects for capital appreciation or some combination of these factors. In particular, **changes** in these policies and trends can be of critical importance in altering the rates of return on rental investments versus alternatives - and, therefore, in affecting the volume of new rental investment in any period.

This section reviews how the policies and programs of government and lenders and trends in the real estate market can impact on the rate of return of rental versus alternative investments and how these factors impact the different types of investors.

EXHIBIT 2-11 IMPACT OF INCENTIVES:



2.3.5.1 Government policies and programs

Governments can have a major impact on the economics of rental investment. Few suppliers of private goods and services are as heavily influenced by the actions of government as rental housing suppliers. The main ways in which government can affect the returns to rental investment are through:

- Incentive programs for private investors;
- Government supply;
- Interest rate policies;
- Rent controls;
- Landlord/tenant laws;
- Condominium conversion laws;
- Restrictive practices with respect to land approvals, development changes, required donations, building codes, etc.; and
- Tax policies.

Each of these is reviewed below.

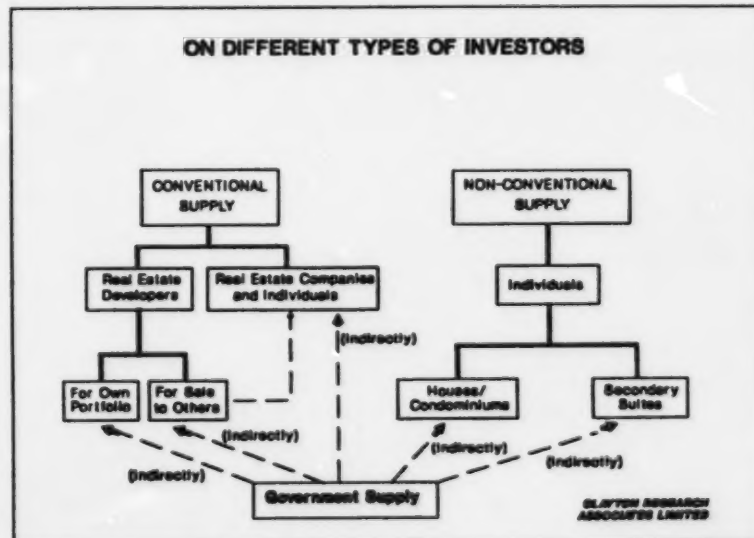
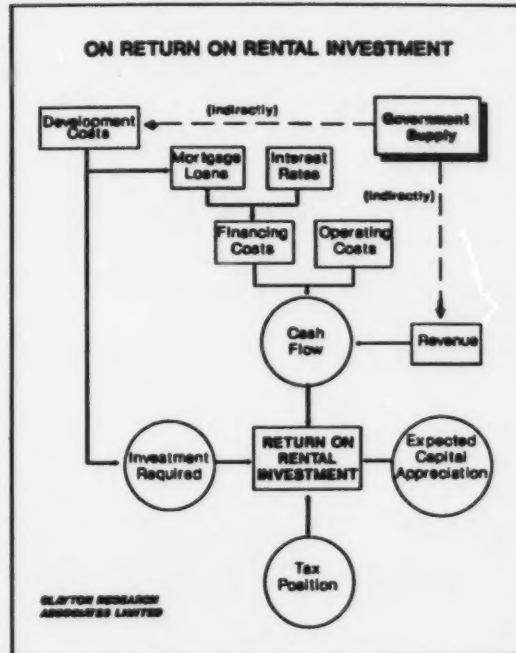
2.3.5.1.1 Incentive programs for private investors

The government can provide incentives (such as grants or interest-free loans) to attempt to stimulate private rental construction. Subsidies of this type can make new construction more attractive by reducing costs - and, hence, reducing either the amount of equity required or the initial negative cash flow on a rental project.

Incentives to stimulate investor interest in rental housing have, in the past, been a common means for government to intervene in the rental market. Grants, interest-free (or low-interest) loans or interest subsidies can make rental investment more attractive by:

- **Reducing the size of the required investment** - to the extent they are provided in addition to the available financing, grants or low-interest loans reduce the size of the investment required, or
- **Improving the cash flow** - to the extent they replace the market rate mortgage financing that would have been used, grants or low-interest loans have a beneficial impact on cash flow.

EXHIBIT 2-12 IMPACT OF GOVERNMENT SUPPLY



Either way, they make a potential investment in rental housing more attractive. For projects on the margin, they may tip the balance in favour of an investment in rental housing.

In general, incentive programs do not have a significant impact on the prospects for capital appreciation unless the program is sufficiently large to cause a major increase in rental housing supply (in which case, expected capital appreciation would be lowered). Similarly, these programs do not have a major impact on the tax position though, of course, to the extent they improve cash flow, potential deductions for losses against other income may be reduced.¹³

For different types of investors, incentive programs generally would have a similar impact. Incentive programs are generally directed at conventional rental construction, although programs to encourage the construction of secondary suites may also take place in centres with extremely tight rental markets.

2.3.5.1.2 Government supply

Private investors are not the only source of rental supply - rental housing supply is also initiated by governments. In general, this supply is motivated by a consideration of providing adequate housing at a reduced rent for those who are unable to afford private market accommodation. However, a large degree of social housing may actually be occupied by "market" tenants, to the extent that a mix of tenants is perceived to be socially desirable.

Making a portion of government-initiated housing units available at market (or below-market) rents to tenants able to afford to compete in the private market provides competition to private rental construction, which indirectly impacts on market rents and the volume of demand for private rental units - so higher vacancies may be expected. In addition, public supply competes with private market suppliers for limited resources (such as land and construction labour and materials), which may increase the price of resources to private market investors.

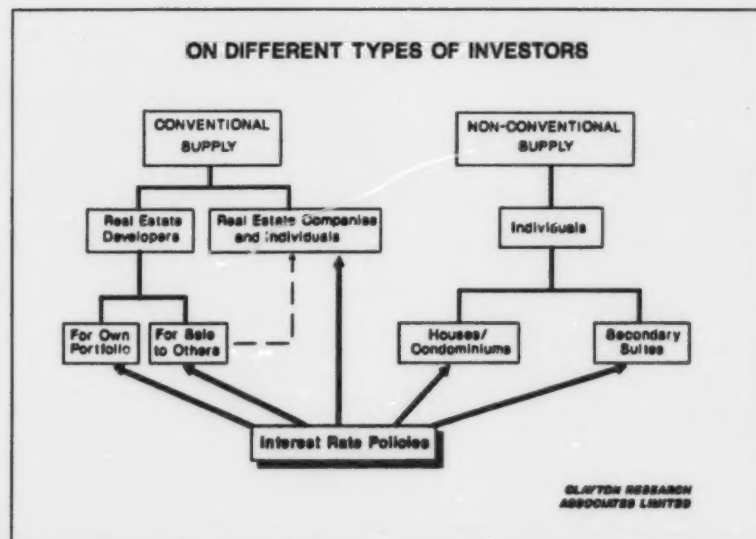
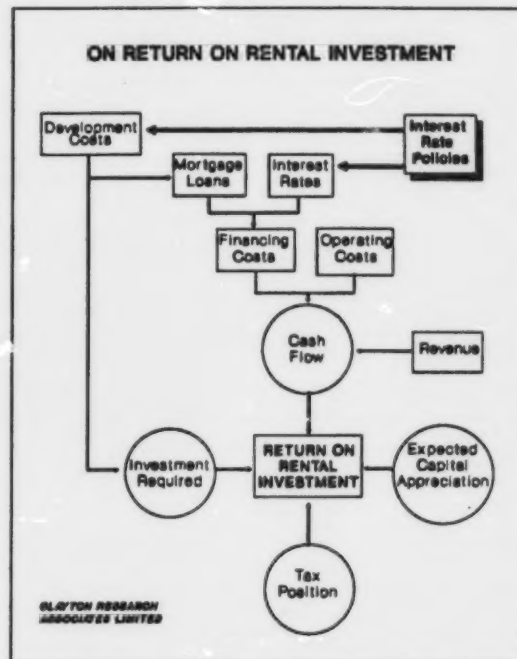
Government supply of rental housing may also impact financing costs, to the extent there is competition created for limited mortgage funds.

To the extent that government supplied rental housing exerts downward pressure on rents for private units, all types of investors are impacted. Developers are also directly impacted by any increases in development costs resulting from the competition for resources.

13 This section ignores the potential for government to provide incentives through the tax system. These are discussed in the section on tax policies.

EXHIBIT 2-13

IMPACT OF INTEREST RATE POLICIES



2.3.5.1.3 Interest rate policies

Interest rates are generally set by the policies of the federal government, either through inaction (i.e. letting the rates be determined in the marketplace without intervention), or by following specific policies.

Higher interest rates lead to immediate declines in the financial viability of rental projects as they produce higher financing costs. Therefore, they directly impact both initial cash flow and expected future cash flows. Also, to the extent that interest costs during the construction phase of a rental project are affected, project development costs are affected as well.

To the extent that most investors in rental housing use financing either to construct (developers and creators of new secondary suites) or buy (buyers of conventional units or single house/condominiums or homes with secondary suites) rental properties, higher interest rates reduce cash flow for all types of investors.

For the investor in secondary suites, the overall impact of higher interest rates may not be clearcut. Higher interest rates may provide an incentive for a homeowner with some unused space to supply secondary suites to obtain rental income to help with higher mortgage payments - though, as always, the gains through the added income would have to outweigh the costs involved in conversion.

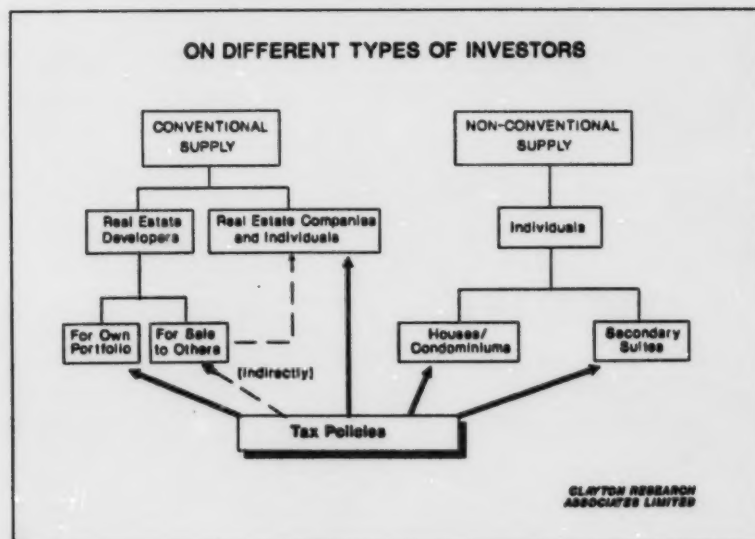
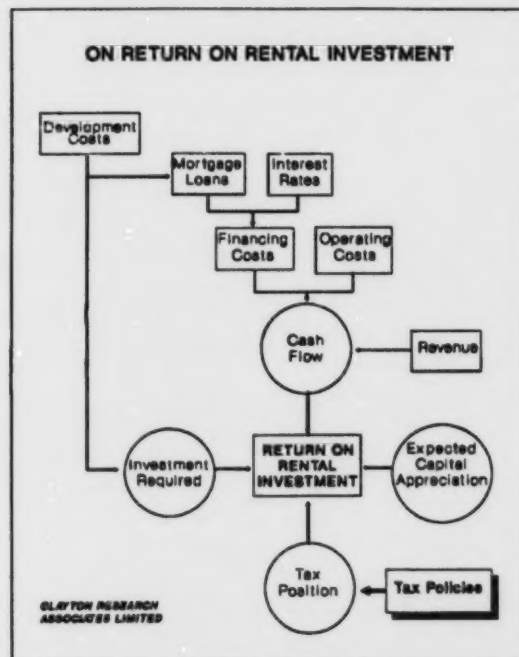
2.3.5.1.4 Tax policies

The implications of rental housing investment for an investor's income taxes are a key part of the investment decision for most investors.¹⁴ This is demonstrated by the treatment of the investor's tax position in this analysis as a distinct component in determining the rate of return on rental investment. Of particular importance are:

- The calculation of expenses - for tax purposes, losses may be created not only through negative cash flow but also through allowances for depreciation on the building and equipment (called capital cost allowance or CCA) and the immediate write-off of certain costs associated with the development or acquisition of the property (called soft costs).
- Use of rental losses and write-offs against income from other sources - one of the key attractions of rental housing from the point of view of many potential investors is the ability to use the losses and write-offs generated by rental investment to shelter income from other sources from income taxes.

14 This section deals with the income tax implications of rental properties only. Property taxes are considered as part of operating costs.

EXHIBIT 2-14 IMPACT OF TAX POLICIES



The type of **expenses** and **write-offs** often involved in the development, acquisition and operation of rental property include the following:¹⁵

- **Cash flow** - in the early years of an investment in rental property, before-tax cash flow is often negative, i.e., revenues are insufficient to cover expenses. When cash flow becomes positive, it is subject to income tax unless there are compensating deductions of other expenses. Properties with a positive cash flow can, if there is sufficient value, be refinanced with a larger first or second mortgage to (a) provide for a tax-free withdrawal of capital by the investor and (b) recreate a negative cash flow.
- **Capital cost allowance** - allowances for depreciation of the cost of the building and equipment may be at a faster rate than actual depreciation. Different rates of capital cost allowance may apply to buildings of different types as well as various types of equipment.
- **Soft costs** - certain types of costs incurred in the development or acquisition of a rental building may be, given the rules applying in any particular time period, deductible up-front as business expenses. These have included a wide variety of expenses over the years, such as interest and property taxes during construction, architects' fees, building permits, costs incurred in borrowing money (such as various types of mortgage fees), legal, appraisal and accounting fees, landscaping costs, promotion and advertising costs and pre-opening and start-up costs.
- **Interest costs** - the interest payments on loans required to finance the rental investment other than the mortgage loan (e.g., an equity loan) may be deducted from income.

The ability to deduct certain expenses is important, but also important is whether these deductions are restricted to income from the rental property only, or can be used to shelter income from other sources such as employment earnings.

Another tax aspect associated with rental housing investment is how capital gains from rental investment are treated.

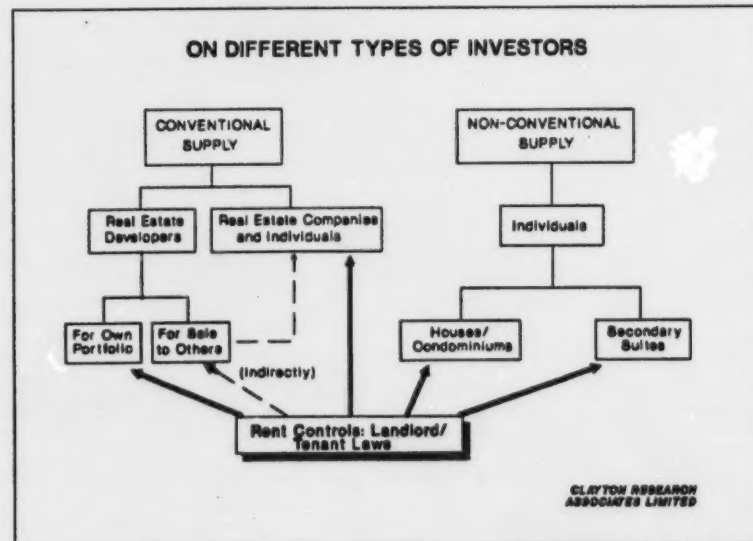
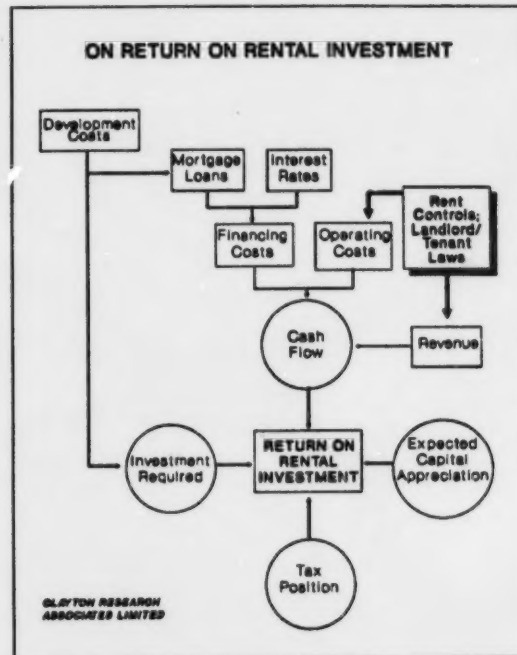
The impact of these tax considerations on different types of investors will depend on whether the deductions are allowed for all or only some types of investors, as well as their specific marginal tax rates.

These favourable income tax aspects of rental housing investment have been promoted by developers of syndicated "tax shelter" offerings, particularly in situations that do not support the economic viability of rental projects strictly on a cash flow basis. In tax shelter projects, "units" are generally sold to high-income (and therefore

¹⁵ This section simply outlines the possibilities for these expenses/write-offs; how they have been treated in different periods in Canada are examined in Chapter 3.

EXHIBIT 2-15

IMPACT OF RENT CONTROLS AND LANDLORD/TENANT LAWS



higher tax bracket) investors who use rental income losses generated from the project to shelter income from other sources.¹⁶

To the extent that most holders of rental property can take advantage of some aspect of favourable tax policies, they are directly impacted. Developers who sell to investors are indirectly impacted to the extent that tax policies influence a potential buyer's expected rate of return and decision to purchase.

2.3.5.1.5 Rent controls

Rent controls generally impose some cap on market rents which directly impacts the revenue from a rental property. Also, to the extent that rent controls involve additional "red tape" for landlords planning improvements, repairs, refinancings, etc., they will impact on operating costs as well. Therefore, rent controls affect both the initial cash flow of rental investment and future expected cash flow. So even if the economics of the rental investment are attractive in the early years, to the extent that rent controls restrict future rent increases, and impose higher costs, cash flow may not increase (and could decline) in coming years. Therefore, the presence of rent controls impacts both cash flow and expected capital appreciation.

Rent controls do not have to be in effect to impact rental investment decisions. If an investor perceives there is the possibility of their imposition at some point in the future, expectations of future cash flow (and capital appreciation) may be negatively impacted.

As rent controls impact market rents, they impact the cash flow expectations of all types of rental investors. Developers marketing new rental properties will not be directly affected (except to the extent that they might provide cash flow guarantees), but rent controls indirectly impact their returns in that the price investors would be prepared to pay for a given rental property will likely be less in a rent controlled market. Owners of rental properties where the rents are suppressed below market levels by rent controls are directly affected since the value of their properties (and their cash flow) will be lower.

Rent controls may give a comparative advantage to investors in non-conventional supply, as they may be in a better position to implement "illegal" increases above the rent controlled rents (as "illegal" rent increases are less readily monitored in this sector).

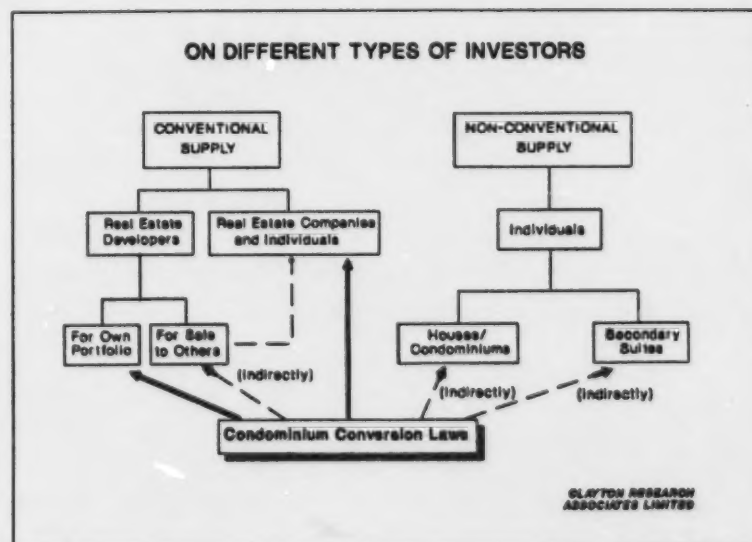
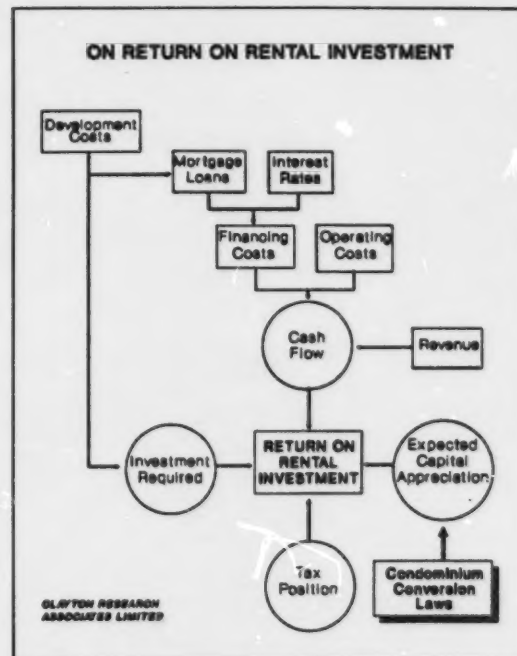
2.3.5.1.6 Landlord/tenant laws

The exact provisions of any landlord and tenant laws will determine their actual impact but in general they act to decrease the cash flow on rental investment by adding to the costs of operation or reducing revenues. For example, provisions may

16 Tax shelters are discussed in more detail in Chapter 3.

EXHIBIT 2-16

IMPACT OF CONDOMINIUM CONVERSION LAWS



make it difficult to evict for non-payment of rent - not only is rental income foregone, but costs of legal services (and perhaps damage to the unit) may also be incurred.

As with rent controls, uncertainty about future changes to regulations may impact expected future cash flow (and therefore capital appreciation) as well, to the extent that potential investors believe the rules of the game may change.

All potential investors for whom cash flow is a consideration are impacted by these regulations. For developers selling buildings to other companies and individuals, the impact is more indirect, as it could affect potential sale price.

2.3.5.1.7 Condominium conversion laws

Laws which restrict conversion of rental units to condominiums can reduce the expected future capital appreciation of buildings to the extent that condominium prices are above the prices of rental units. Many investors purchase rental housing with the intention of selling the buildings at a later date as condominiums - or at least retaining that option. Initial development of a condominium building as rental may also have some advantages in terms of receiving rental incentives (as discussed above) or for tax write-offs.

As with rent controls, even if conversions in an area are not restricted at the time, expectations that they may become so in future may impact expected potential returns for some investors.

These laws directly impact potential investors who are holding a property until a future date at which time the conversion of the property to condominiums would be an option. Developers selling buildings or units as tax shelters are indirectly impacted, in that it may affect selling prices if buyers expect lower returns.

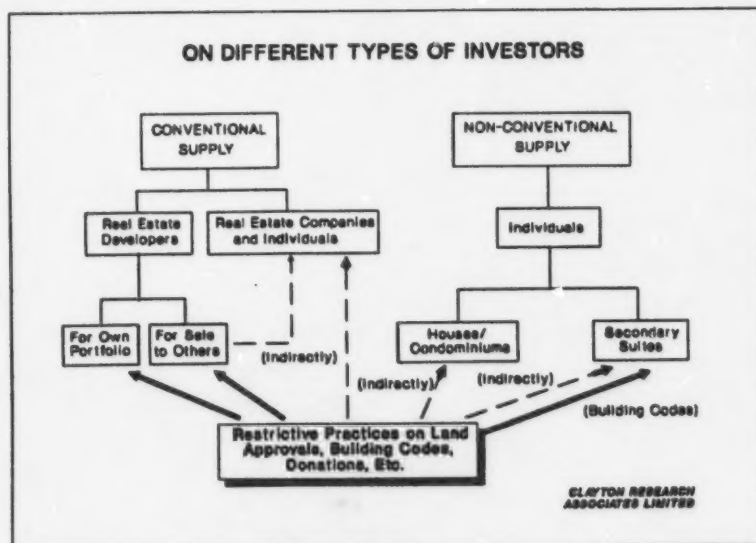
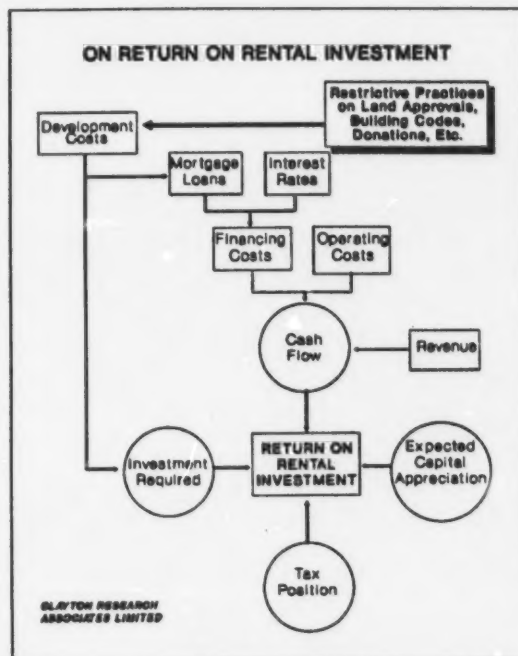
Investors in rental houses or condominiums and investors in secondary suites may also be indirectly impacted either, positively, to the extent that conventional rental investment is reduced because it is less attractive, or, negatively, to the extent that units which would otherwise be taken out of the rental stock (by conversion to condominiums) continue to offer competition.

2.3.5.1.8 Restrictive practices with respect to land approvals, development charges, required donations, building codes, etc.

To the extent that governments impose restrictions on development in any form, this is reflected in higher costs which, in turn, impact the economics of the investment.

Examples of such restrictions include:

EXHIBIT 2-17 IMPACT OF RESTRICTIVE PRACTICES



- Complex approval processes and/or policies which do not provide an ample supply of pre-zoned land - this can result in shortages of land in the short-term (and therefore higher land prices).
- Development charges intended to alleviate the burden of new development on municipalities - this imposes a direct cost on development.
- Requirements for donations of land, facilities of some type or cash-in-lieu - these all require contributions which raise development costs.
- Unnecessarily strict building codes - these impose additional costs for construction.

These types of restrictions all increase the costs of development. This increased cost flows through either to an increase in the mortgage (and, therefore, negatively impacts on cash flow) or a greater initial investment on the part of the investor - or both. In either case, the return on rental investment is reduced.

All types of investors in rental property are affected by these restrictive practices, although in varying ways. For developers, these practices add directly to up-front development costs. Companies and individuals purchasing buildings, condominiums or houses are affected indirectly by these practices through higher purchase prices. For investors in secondary suites, a negative impact would result from required compliance with building codes when creating a unit. There would, however, also be an indirect positive impact to the extent that these restrictive practices reduce competitive conventional supply and thereby raise potential rents.

2.3.5.2 Lender policies

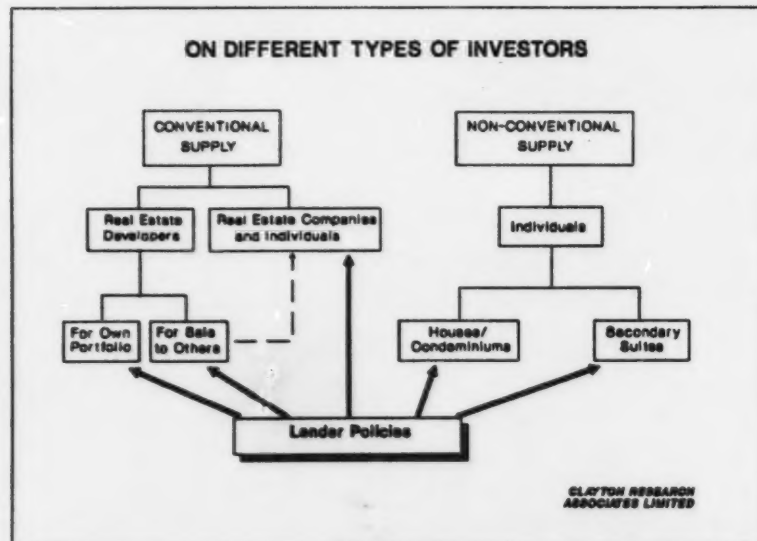
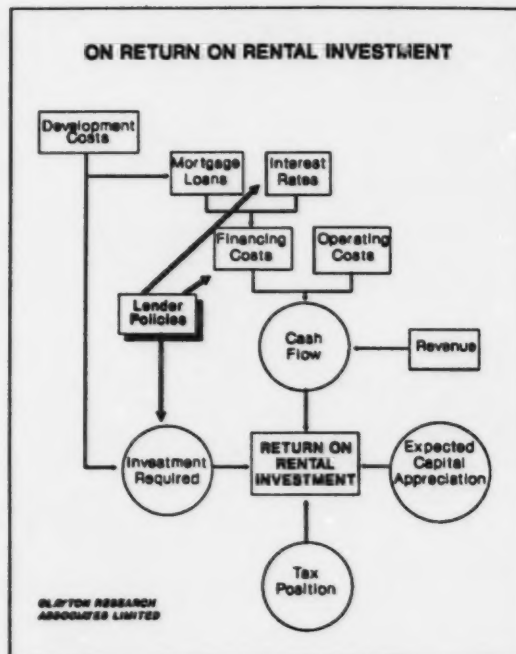
Most rental investors, whether large or small, depend to some degree on financing; the exception is investors in secondary suites who are often able to pay for any alterations required to create the space from personal savings.

The proportion of the investment costs which is financed is critical to the rate of return on the investment. The higher the proportion of equity required, the lower the rate of return will be, as measured against the original investment.

Lenders have historically dictated the degree of financing obtainable for a project on the basis of the expected income stream. The size of mortgage payments that the investor can be expected to handle, given expected operating costs and a cushion for unforeseen circumstances, without incurring an unmanageable negative cash flow, dictates the size of the mortgage the lender is prepared to offer. Alternatively, additional security in the form of personal guarantees etc. may provide the basis for a larger loan than the cash flow from the project may support.

In times of relatively high interest rates, greater equity would generally be required because the higher mortgage payments associated with the higher rates would reduce

EXHIBIT 2-18 IMPACT OF LENDER POLICIES



the cash flow on a project. Because lenders provide financing on the basis of the perceived economic viability of a project, certain market conditions, such as rent control, may affect lender policies, to the extent that they affect overall project viability.¹⁷

Lender policies, particularly in terms of competing for business, also affect mortgage rates.

Track record can play an important role in acquiring financing. A large developer who has shown he can make a project work or who has the resources to weather periods of negative cash flow may be viewed more favourably by lenders than a new, "unknown", investor.

2.3.5.3 Real estate market trends

Activity in other parts of the real estate market such as condominiums, other types of ownership housing or non-residential development can have an impact on the returns from rental investment. In particular, by affecting the demand for land and construction labour and materials, trends in these markets can affect the costs of producing rental housing. Also, to the extent that ownership and rental housing are substitutes, trends in prices in the ownership market will affect the demand for rental housing. Each of the major factors here is reviewed below.

2.3.5.3.1 Land costs

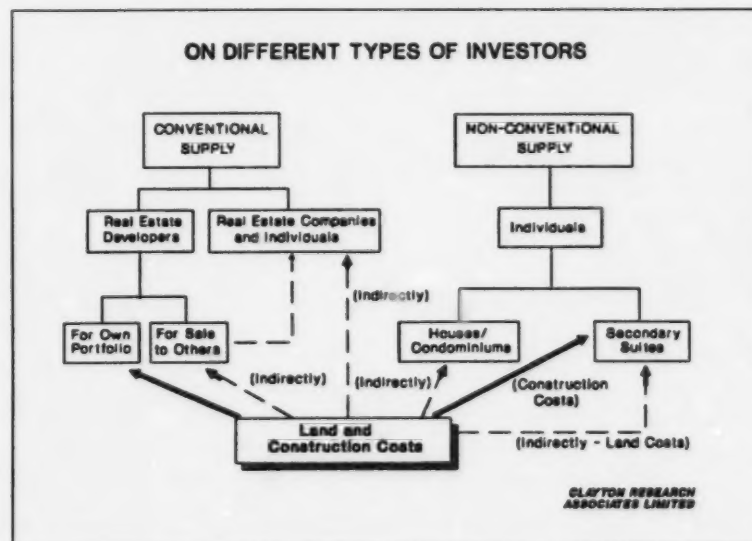
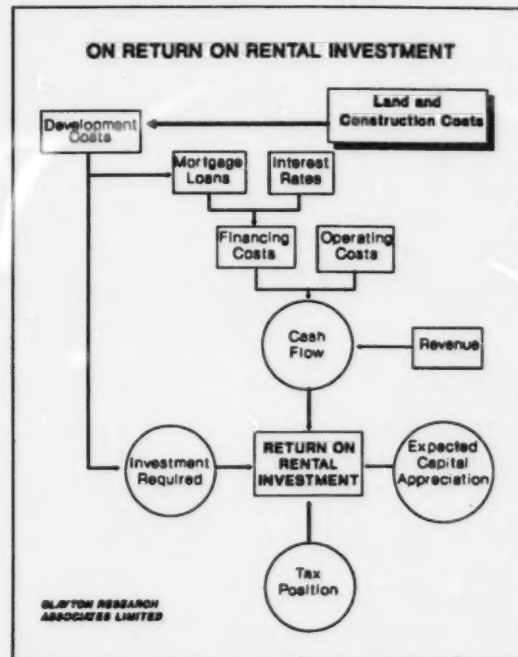
The availability and price of land has a direct impact on development costs. There are several factors which directly impact land price:

- **Location:** generally land costs decrease as development moves outward from the central core.
- **Competition from other uses:** to the extent that other uses may provide higher returns, developers of these other types of projects can afford to pay more for land, bidding up the price to rental suppliers. In particular, condominium development, which is a substitute use for multiple residential land and therefore competes directly with rental projects for land, can impact land costs to rental developers.
- **When purchased:** often, developers may have a parcel of land that they have owned for some time. To the extent that land prices are generally increasing over time, this can provide a cost advantage relative to having to purchase at current prices as well as reducing the amount of equity required from other sources. However, for a realistic analysis, the opportunity cost

17 Environics Research Group, **Financing Residential Rental Accommodation: A Survey**, a study prepared for the Commission of Inquiry into Residential Tenancies, 1985.

EXHIBIT 2-19

IMPACT OF LAND AND CONSTRUCTION COSTS



for the land, e.g., what could be obtained by selling the undeveloped land for other types of development, such as condominium, should be taken into consideration in the analysis of the land cost, not original purchase price. If there are no potential buyers for the land, the opportunity costs would be zero.

In addition, there are indirect land costs, such as the process of zoning (in areas without pre-zoning) or re-zoning land for high-density usage, as well as property taxes. However, these indirect costs are most appropriately considered as part of operating costs (in the case of property taxes) or the restrictive practices with respect to land development (in the case of zoning processes - see Section 2.3.5.1.8).

Land costs directly impact development costs, and therefore most directly impact developers. They indirectly impact those investors buying already constructed buildings/units in that they increase the selling price to these investors.

High land costs may enhance the relative attraction of non-conventional supply (especially secondary suites, where land costs are nil) and large developments which use land more intensively; they are a relative disadvantage for small new rental projects which use land less intensively.

2.3.5.3.2 Construction costs

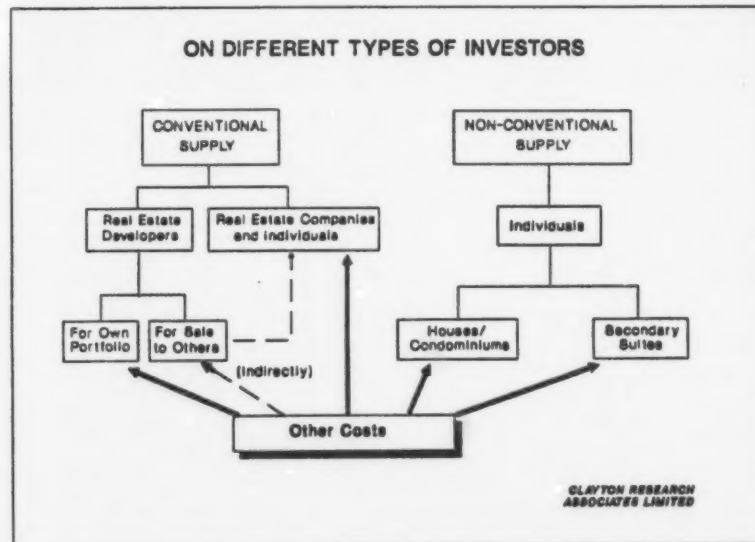
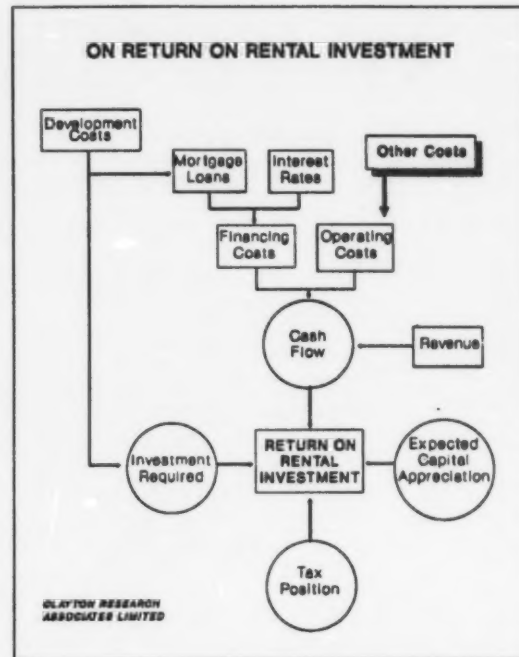
Like land costs, construction costs (i.e. materials and labour, including soft costs) impact directly on development costs, and therefore most directly impact developers of conventional rental projects. Construction costs can be expected to rise with inflation. However, any relative change in real construction costs will make rental investment in that period less attractive than in previous periods.

A sales tax such as the Goods and Services Tax (GST), which applies to the price of new rental projects, will have an impact similar to an increase in the cost of construction (to the extent that it raises the cost of construction).

Competition for construction inputs exerts upward pressure on prices and overall development costs. For private rental supply, competition for resources comes most directly from condominiums and government-sponsored rental housing but also from other types of residential and non-residential construction. To the extent that there is an increase in construction activity in these sources of competition, there will be higher pressure on construction costs to rental suppliers.

The impacts on different types of investors are similar to those for land costs, although creators of secondary suites would also be directly impacted to the extent that the creation of the suite requires construction work.

EXHIBIT 2-20 IMPACT OF OTHER COSTS



2.3.5.3.3 Other costs

Like construction costs, other costs such as costs of maintenance and repair, management costs, property taxes etc. can be expected to rise with inflation - any relative change in these costs, however, impacts operating costs and therefore cash flow and alters the relative returns on rental investment from one period to the next. A tax such as the GST which applies directly to many of these operating costs, will have a similar impact to an increase in these costs.

The impact of other factors, such as rent controls and landlord/tenant legislation, on operating costs were discussed in earlier sections of this study.

To the extent that they impact operating costs, these costs impact most investors directly. Developers who sell to others are indirectly impacted to the extent that changes in these costs may impact the decisions to buy. As well, management costs may differ among investors of different sizes/types.

2.3.5.3.4 Relative costs of homeownership

The relative affordability of homeownership can also impact returns on rental investment. For example, if the relative cost of homeownership declines, there could be a downward shift in rental demand as more households are able to afford the ownership option. In uncontrolled markets, this decline in rental demand could lead to declines in real market rents, which in turn would impact rental revenues and cash flow. All types of investors would be indirectly impacted by this factor.

An increase in homeownership costs, either through higher home values, or carrying costs associated with higher interest rates, would have the opposite impact. In addition, higher ownership costs may provide an additional incentive for homeowners to supply secondary suites, in order to obtain rental income to help with mortgage payments.

However, the relationship between homeownership costs (mainly house prices) and rental demand is not clearcut. To the extent that house prices are rising (or falling) and there is a perception that prices may rise (or fall) further in the future, renters may choose to accelerate (or postpone) a decision to purchase a home. This can have a significant effect on the volume of demand for rental housing.

2.4 RENTAL MARKET FAILURE

This section discusses the concept of market failure in general and in the rental market specifically, how market failure can be identified in the rental market and the potential role of government in addressing it. It establishes the framework within which later chapters of this report will consider whether rental markets have "failed" and whether government intervention may be required to correct the problem.

Because market failure is an abstract economic concept, much of the discussion here is theoretical and technical in nature. The section begins with a brief presentation of the concept in terms of general economic theory before discussing its application to the rental market.

2.4.1 Market Failure Measured as Inefficiency

The concept of "market failure" is neither easily nor uniquely defined. Most often in standard economic analyses, however, market failure is measured in terms of **efficiency**. In this sense, market failure is viewed as the inability of a market to achieve an efficient equilibrium allocation of resources. Efficiency is discussed in this section mainly in terms of general economic theory; its application to the rental market is discussed in more detail in Section 2.4.3.

In any market, the actions of suppliers and consumers come together to determine a level of output and price. For the outcome to be economically **efficient**, the marginal willingness to pay for the good (or "marginal utility"), on the part of consumers, is just equal to the marginal willingness to supply the good (or "marginal cost") on the part of suppliers - and both are equal to the equilibrium price of the good. A market is said to be **Pareto efficient** if the equilibrium outcome cannot be changed in such a way to benefit any individual without **decreasing** the well being of any other individual.¹⁸

Determining whether an inefficient allocation of resources exists (and therefore, market failure) is generally difficult, but certain criteria have been identified in general economic theory as indicative of the presence of market failure. These include:

- **Public goods** - markets do not work for public goods, (i.e., the market for public goods is by nature inefficient), since (1) the consumption of a public good by one individual does not preclude its consumption by another and (2) there is no way to compel individuals to pay for such a good, even though they may be receiving the benefits from it. For example, there is no private market for national defence, since by its nature it provides the service to all members of society, whether they want it (and are willing to pay for it) or not. Rental housing is not a public good, so this potential cause of inefficiency is not present in the rental market.
- **Externalities** - externalities are by-products, with either social costs or benefits, of the marketplace; they indicate inefficiencies in the market. An oft-cited example of an externality is that of pollution. Left to operate freely, consumers and producers in an individual market for a pollution-generating good (say automobiles) might not wish to pay for costly pollution controls. However, there are desirable reasons for dealing with the pollution. In terms of rental housing, there could be externalities in terms

18 The concept is named after the Italian economist Vilfredo Pareto, who first developed the idea.

of social cost; this is dealt with separately here in terms of social goals (Section 2.4.2).¹⁹

- **Market imperfections** - the main sources of market imperfection, according to economic theory, include monopoly power and imperfect information:

- **Monopoly:** in a monopoly, price and output are not determined by the intersection of a supply and demand curve; rather output is determined by the intersection of the marginal revenue and marginal cost curves of the monopolist and price is determined by the point on the demand curve corresponding to that output. Since, in a monopoly, marginal willingness to pay (price) is always greater than marginal cost, monopoly power will always generate a Pareto inefficient allocation of resources - that is, there will be some way to make the monopolist and/or the customers better off.²⁰

Although it might be the case in specific markets, rental markets generally are not characterized by monopolies (or other forms of concentrated supply, such as oligopolies). In most markets, there are many suppliers of rental housing. Therefore, monopolies are generally not a source of rental market failure.

- **Imperfect information:** consumers or producers make their decisions based on the information available to them. These decisions, however, can only be as "good" as the underlying information used to formulate the decision.

For example, for rental housing, an important market signal is vacancy rates. The data from CMHC's Rental Market Survey are the generally accepted indicator of vacancy rates in Canada's major centres. If the vacancy rate for a centre declines to a low level, it is a signal that rents will likely start to rise - and rational producers would examine the economics of supplying more units and, if favourable, would do so. However, the CMHC vacancy rate, although very reliable for the universe it covers, does not cover all rental supply and the extent of

19 It has been argued (see Thomas S. Nesselin, *Alternative Decision-Making Models for Housing: the Question of Efficiency*, Kyklos, Volume 36, 1983) that externalities could exist for housing (for example, there may be social costs associated with slums), but that policy has proven to be ineffective in addressing them.

20 See, for example, Hal R. Varian, *Microeconomic Analysis*, Second Edition (W.W. Norton & Company: New York, 1984), pages 84-85. One way of making both the monopolist and consumers better off is the use of price discrimination. This price discrimination can take place until the competitive level of output is reached.

**EXHIBIT 2-21
IMPACT OF RENT CONTROL**

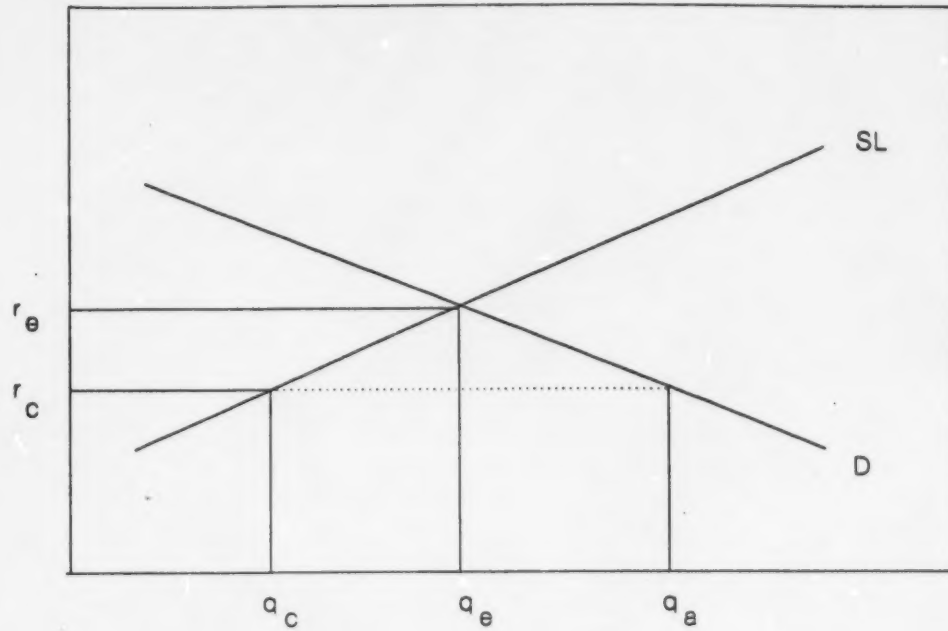
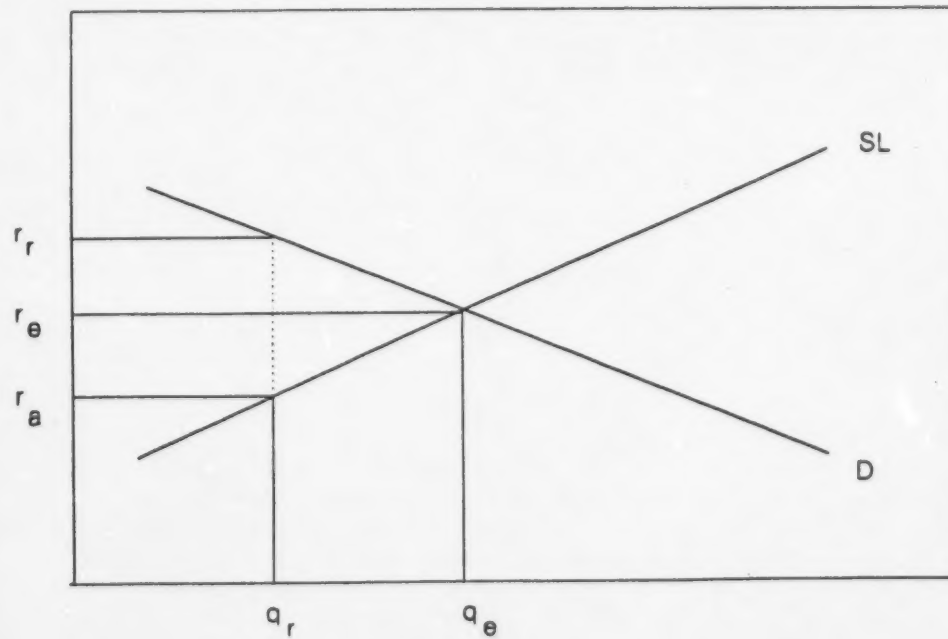


**EXHIBIT 2-22
IMPACT OF RESTRICTED SUPPLY**



coverage varies from one centre to another.²¹ Although it is good information, it is not perfect information.

Based on imperfect information, players may make what appear to be, based on the information available at the time, rational decisions - it is only later, with hindsight, they may not have been rational. To the extent that players are acting in a non-rational manner, inefficiencies will occur. However, under these circumstances, there is a serious question whether government intervention is warranted to render the market more efficient, as governments will in most cases have only the same "imperfect" information available to them.

For the analysis here, two other potential sources of market imperfection in the rental market in terms of efficiency are considered:

- **Government imposed prices or output levels** - if prices and/or output are determined by the government, and not by the interplay of supply and demand, imperfections are clearly present - government, not the market, is dictating prices and quantities.

Price restrictions in the rental market have generally taken the form of **rent controls**. As discussed in earlier sections, with rent controls, rents are not determined by supply and demand, but are imposed upon the marketplace (e.g. r_c in Exhibit 2-21); in this situation, some demand will go unsatisfied (q_d minus q_s).

Output restrictions in the rental market may not be in the form of specific "quotas"; output could be constrained below what would occur under a freely operating market. For example (see Exhibit 2-22), suppliers might be willing to supply a certain level (q_s) of rental housing based on a consideration of the factors underlying the decision process (discussed in Section 2.3) and the quantity demanded in the marketplace. However, due to government actions, suppliers may be unable to supply this amount (e.g., municipal restrictions may limit the amount of land zoned high-density or prohibit secondary suites), so only a lesser amount (q_s) is supplied. Not only is additional (and therefore overall) supply restricted, but existing owners could earn excess profits.

- **Non-rational behaviour** - if actors are not responding to clear market signals in a way which theory suggests they should, this would indicate an imperfection in the market. For example, if rents are at a level where new rental construction would provide a competitive rate of return on investment and there is a shortage of rental accommodation, theory suggests that new supply should be forthcoming (providing land and other factors of production

21 The major exclusions are units in buildings of less than three units, secondary suites and condominium units being rented out by their owners. These can be very important in some centres.

are available); if this does not occur, it would appear that investors are not behaving rationally. This type of situation would appear to indicate market failure.

One must be careful, however, in concluding that agents are not behaving rationally. In the example above, other reasons such as imperfect information, government intervention, extremely attractive rates of return on alternative investments or the lags inherent in bringing new projects on stream may be responsible for the lack of new rental construction - in view of these, investors' behaviour may be more rational than is at first apparent.

In general, all markets for goods and services suffer from some degree of market failure because, except for markets which are perfectly competitive, imperfections result in at least some inefficiencies.²² Since no markets are perfectly competitive, in a pure sense, all markets fail. There is a need therefore to consider **degrees** of market failure in terms of efficiency, as is discussed later in the context of criteria for assessing rental market failure.

2.4.2 Social Goals Are Also Important

To many, the concept of market failure goes beyond the idea of efficiency to include social goals. Viewed from this perspective, an **efficient** allocation of resources may be present, but the resulting outcome may not necessarily be socially acceptable.

Each consumer's participation in a market is determined by his/her **ability** to participate, as reflected by income and assets. For each possible distribution of income and assets among consumers, there is a different competitive and efficient market solution. However, the market system does not provide a mechanism for determining which solution is "best"; this is determined by social goals.

Few would disagree that society has an obligation to ensure adequate affordable housing is available for all. However, what exactly does "adequate" or "affordable" housing entail? The definitions adopted are obviously crucial to any assessment of the degree of market failure in terms of social goals.

In terms of "affordable", the most commonly used criteria is that households should not have to spend more than 30 percent of income on housing. The definition of "adequate" housing is less clearcut. Most often, however, it is interpreted to mean housing which is comprised of self-contained units - that is, having their own bathroom, kitchen and living facilities. Moreover, it is also often interpreted to mean that at least some of the "affordable" housing required for low and moderate income persons should be provided through new construction.

22 See Section 2.1.2 for a description of some of the factors (such as transaction costs of moving and vacancies, non-homogeneous commodities and supply lags, etc.) which may hinder the efficient operation of the rental market.

However, the provision of adequate additional housing need not consist of either new or self-contained units. Other options, such as units created within the stock (e.g. secondary suites), communal facilities, or even by doubling up, can also provide adequate housing for some groups, depending on the definition of "adequate" which is embraced. Furthermore, social goals must determine whether access to separate units will be available for all those who want them, or for all those who truly need them. The availability of government assistance for rental housing may in fact encourage the formation of individual households which otherwise might have pursued other options, such as doubling up with friends or staying longer in the parental home (or in the case of seniors, living with their children).

Furthermore, the provision of adequate housing might instead take an income focus - i.e., not supplying "affordable" units directly, but supplementing incomes such that those in need can participate in the private market.

In general, most markets do not serve families and individuals with very low incomes adequately. Whether for groceries, childrens' clothing or rental housing, the unfettered operation of the market will result in an inadequate allocation of resources to those with very low incomes. Therefore, in terms of equity, most markets can be considered to have failed and, therefore, government intervention in some form is required to provide for these families and individuals.

However, social goals can also be expressed in terms of broader social issues such as whether the market is providing an "adequate" range of choice, even for those who are not in financial need: is the market providing sufficient "affordable" rental housing in good locations as well as the luxury rental housing that seems to dominate new rental developments in many centres?

Assessing the performance of the rental market in terms of this type of broader social goal is extremely difficult; it requires value judgements on what is "adequate" or "affordable" as well as measurements of supply and demand at various levels of rent and unit size which are not readily available.

Because of high costs, most new conventional rental projects require rents which are well above the range that many would describe as "affordable" - unless significant subsidies are provided. This is true whether the projects are built by the private sector or by non-profit or public agencies. If this inability of conventional new production to provide low-rent projects is considered evidence of market failure, then most rental markets in Canada nearly fail. However, such a view overlooks the fact that low-rent accommodation is traditionally supplied through other means:

- **The filtering process** - excluding publicly subsidized housing, most of the "affordable" conventional rental housing in Canadian cities is in the older stock. This is a reflection of the filtering process whereby housing, as it ages, becomes less desirable and, therefore, less able to command high rents than newer, more desirable units. Higher-income tenants tend to occupy newer, higher-rent housing while older generations of rental units become less desirable - as reflected in lower relative rents and lower-income tenants.

- **Non-conventional units** - units created within the existing stock, especially secondary suites, provide rental accommodation at rents which generally are considered "affordable" by most observers.

Thus, when assessing whether rental markets are serving the broader social goal of providing a full range of rental housing, it is simplistic merely to look at the range of housing being produced through conventional rental construction. Other sources of supply are important contributors of lower-rent (more "affordable") rental accommodation.

2.4.3 Criteria for Assessing Rental Market Failure

As noted above, in the real world, few if any markets are without at least one of the characteristics which indicate market failure, either in the strictest sense of efficiency or with regards to social goals. The rental market is no exception.

However, the primary purpose for identifying the presence of market failure is as a basis for determining **whether government intervention may be warranted** to correct the failure. Recognizing this, the following criteria have been used to assess whether the rental markets have failed in terms of either efficiency or social goals and whether government intervention is warranted.

2.4.3.1 Measuring rental market failure in terms of efficiency

As discussed earlier, a primary guide to whether rental markets are operating efficiently is provided by whether agents are responding rationally to market signals. Recognizing that no market operates with perfect efficiency, the following are two extremes which will be used in this study to assess whether individual rental markets have failed in terms of efficiency and whether government intervention is warranted:

- **Minimal market failure:** rental housing suppliers and consumers are responding rationally to market signals. Because of the nature of the rental market and because available information may be imperfect, some degree of market failure exists; however, decisions are consistent with the information available. For suppliers in particular, outside factors (such as government programs/policies, lender policies and real estate market trends) may be present which influence their decisions (see Section 2.3.5); however, as long as the decision process takes account of these factors in a rational manner, then market failure is viewed to be minimal.

Of particular importance in this regard is the effect of lags in the rental market. Whether in terms of the lag between shortages occurring and rent increases, or the lag between a decision to build and the actual completion of a building, it is important to recognize the effect of lags on rental market operation when measuring the degree of market failure.

Markets exhibiting this minimal degree of market failure are considered to be generally effective markets in terms of the efficiency criteria. This degree of market failure is not generally considered to warrant government intervention on efficiency grounds.

- **Substantial market failure:** this type of market failure is present if (1) agents are shown to be reacting to market signals in a non-rational manner, or (2) inappropriate intervention by governments has damaged the price or output mechanism. The former might be, for example, all other things being equal, suppliers not building new projects when vacancy rates are low and new production would earn a competitive rate of return. The latter would be characterized by actions such as the imposition of rent controls, which directly intervene in the market and prevent it from attaining an equilibrium price and output and therefore result in an inefficient allocation of resources.

Markets exhibiting this type of market failure are considered to be ineffective markets and, depending on the action proposed, may warrant government intervention to improve efficiency.

Between these two extremes is a continuum of possible outcomes which may or may not warrant government intervention depending on the circumstances.

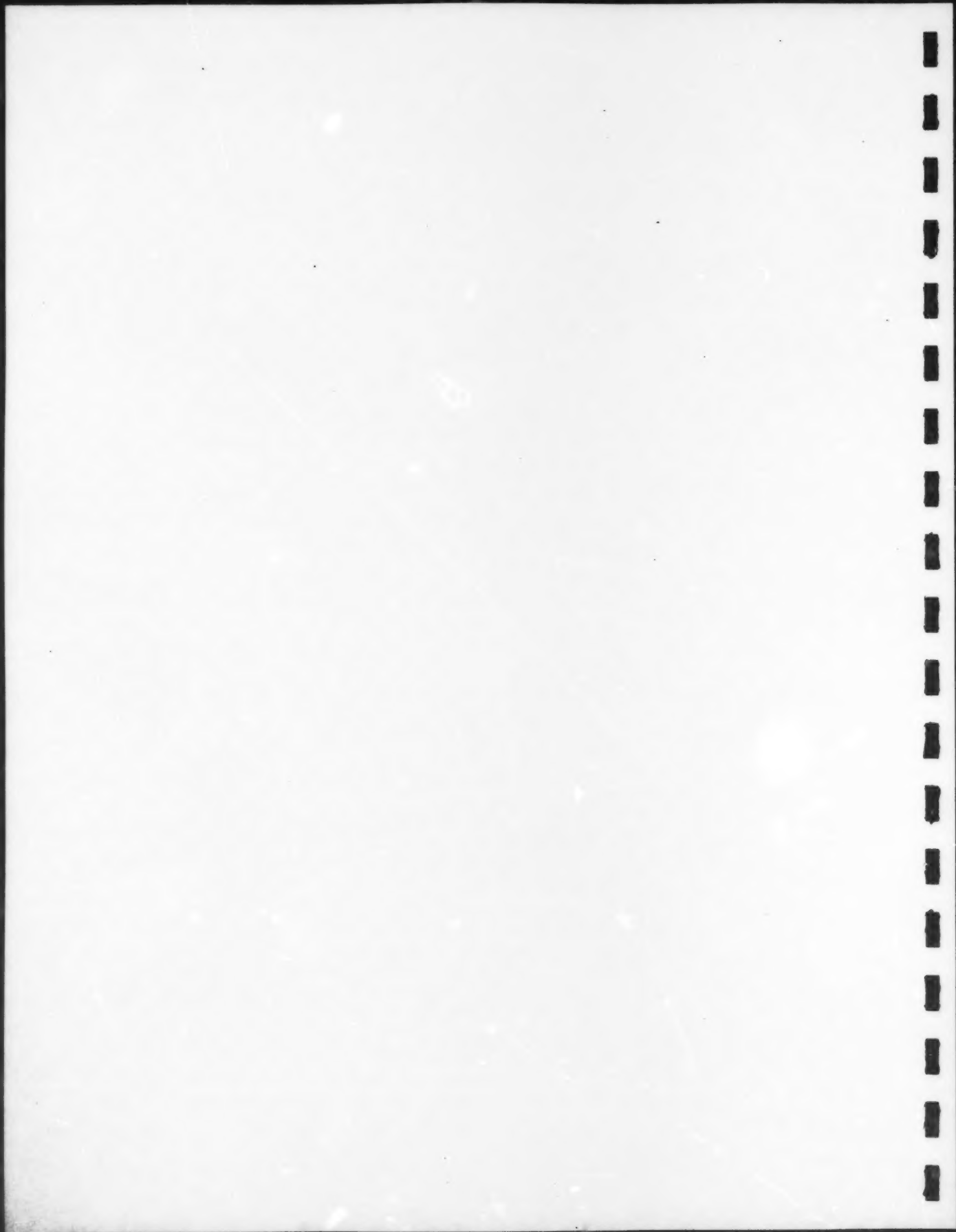
2.4.3.2 Measuring rental market failure in terms of social goals

Intervention in rental markets on the basis of social considerations is generally premised on a belief that (1) all members of society have a basic right to **adequate** and **affordable** housing but there are some renters with incomes too low to even allow them to participate in the private market or (2) the market is failing to provide an adequate level of consumer choice for market driven supply.

No matter what the source or volume of rental housing produced, nor the definition of "adequate" or "affordable" adopted, there will **always** be some whose incomes are so low that they cannot afford to obtain adequate rental housing on the private market. For these, under the "equity" definition of market failure, the market will have failed and some government intervention (e.g. social housing, shelter allowances or other income supplements) will be necessary.

Clearly, there is a vast need for government assistance to needy renters: CMHC estimates that over 900,000 Canadian renter households are in core need (they cannot obtain adequate rental accommodation without spending more than 30 percent of their income on rent).²³ Whether this is the correct number (or whether it is half or double this) is not important in the discussion here. What is important is that, when society (through government) makes the judgements about "adequacy" and

23 John Engeland, "Canadian Renters in Core Housing Need" as appeared in *Canadian Housing*, Winter 1990-1991.



"affordability", a substantial proportion of the renting population will be defined to be in need and that these renters cannot obtain the standard of housing they need without some government assistance. Such needy renters are present in all rental markets so government intervention is required if the goals of society are to be met.

The other aspect of social goals is whether the private market is providing a sufficient degree of consumer choice to the remaining renter population (i.e., those without very low incomes). In any particular market there will be a range of market demand, from modest units through luxury accommodation. The higher end of the market is generally satisfied through newly constructed units, condominium units offered for rent and older units which have been upgraded. At the other end of the market, the cost of new construction in most centres generally prohibits the provision of modest market units through new projects. This does not, however, mean that modest units will not become available to those who need them; as noted earlier, there are other means of supplying them such as the creation of additional secondary suites within the existing stock and the filtering down of existing units.

Measuring rental market performance in terms of this broader social goal is extremely difficult. Adequate measures of either the volume of secondary suites being created or the filtering of units over time are not generally available. Still more difficult is measuring whether these are "adequate" to provide choice or assessing whether a perceived failure of the market to provide an "adequate" range of choice is justification for government intervention. And what type of intervention?

2.4.4 Government Intervention in the Rental Market

The existence of market failure provides a rationale for government intervention in the rental market. However, market failure should be considered only a **necessary** condition for government intervention - in itself it is not a **sufficient** condition, since, in terms of market efficiency, the government may not be able to do any better than the market mechanism. In terms of social goals, if it is decided to intervene in the market, the challenge is to do so in a cost-effective manner without destroying (or, at least, reducing) market efficiency.

Methods in which governments can intervene directly in the rental market include regulations (e.g., the imposition of rent controls which prevent the free market determination of price or restrictions on suite sizes for new units to make them "affordable") or the direct production or subsidization of rental housing. Another alternative is to examine existing policies or regulations which may be restricting the operation of the market. Such methods may seek to correct perceived market failure in terms of efficiency or the social goal of promoting a more equitable distribution of output. However, as by their nature these measures may preclude an efficient allocation of output, market failure in terms of the efficiency of the rental market may be exacerbated.

Governments can also intervene indirectly to promote social goals through actions which redistribute income among households. These methods have more potential

EXHIBIT 2-23

CRITERIA FOR ASSESSING MARKET FAILURE AND NEED FOR GOVERNMENT INTERVENTION IN THE RENTAL MARKET

Type of Market Failure and Criteria	Government Intervention Warranted?
1) EFFICIENCY	
<i>Minimal Failure:</i>	
Available information may be imperfect but agents are acting consistently with perceived market signals	No
<i>Substantial Failure:</i>	
Agents are reacting irrationally to market signals	Perhaps
and/or	
Government intervention has created inefficiency	Yes
2) SOCIAL GOALS	
Some persons have incomes so low that they cannot obtain adequate housing at a price they can afford	Yes
Choice and range of market driven supply limited; filtering process not working; no non-conventional supply	Perhaps

for resolving market failure as they can result in more equitable distributions of output, **without sacrificing efficiency** - if, indeed, efficiency is not considered a serious problem. Shelter allowance programs, or other means of redistributing income through the taxation system, are example of such intervention.

In deciding if government intervention in any particular rental market is warranted, it is necessary to assess whether (1) the degree of failure is minimal or whether it is sufficient to warrant government intervention and (2) whether the proposed intervention will indeed exact an improvement. To assist in this assessment, Exhibit 2-23 presents a summary of the criteria to be used in this study to assess whether the rental market has failed in terms of either efficiency or social goals and whether government intervention is warranted.

- **Efficiency** - as discussed, no markets operate with perfect efficiency; two extremes of inefficiency are identified:
 - minimal - agents in the market are reacting rationally in response to market signals. In this case, government intervention cannot be justified on efficiency grounds.
 - substantial - two criteria are offered here:
 - agents are not responding rationally to market signals. In this case, government intervention may be warranted providing the signals are clear and government action can improve efficiency.
 - government intervention is creating inefficiency. Past actions of government may be preventing the efficient operation of the market; action by government would be warranted in this case to remove the intervention or ameliorate the effects.
- **Social goals** - two potential justifications for government intervention are apparent in terms of achieving social goals:
 - low incomes and special needs among a segment of the renter population justify government action to ensure that they have "adequate" shelter at a cost they can afford. Government intervention is clearly required in this regard as the private market cannot deal with this problem.
 - broader social goals such as the provision of an "adequate range" of "affordable" housing are, as discussed above, much more difficult to measure. Generally, lower-rent housing is provided through the filtering process and non-conventional supply such as secondary suites. Evidence that such accommodation is not forthcoming may, in the view of some observers, justify government action if the net effect of such intervention will improve the situation. Prior to making such conclusions, however, clear definitions of "adequate range" and "affordable" are required.

Government intervention in the rental market in terms of social goals must, however, take account of the effect on the private sector in order to minimize the potential for substantial losses in rental market efficiency. Well-intentioned efforts to achieve social goals through intervention in the rental market can be counter-productive if they significantly affect the economies of private market housing.

The criteria outlined in Exhibit 2-23 are used in later chapters of this study to assess whether the rental market in Vancouver has failed (based on an examination of market trends and the economics of new rental construction) and potential government actions to improve the workings of the market in Vancouver.

CHAPTER 3

OVERVIEW OF RENTAL MARKET TRENDS IN CANADA

This chapter provides a review of the main trends in rental housing in Canada over the past two decades. The levels and composition of production are examined at the national level, as well as the changes in government and lenders' policies and real estate market trends which have impacted the supply of rental housing. The chapter concludes with a brief review of overall rental market trends in the five centres (Calgary, London, Winnipeg, Montreal and Vancouver) selected for more intensive examination in this study and the reasons for their selection.

3.1 RENTAL HOUSING PRODUCTION IN CANADA

This section provides an overview of the levels of rental housing production in Canada over the past two decades.

3.1.1 Rental Production Difficult to Measure Accurately

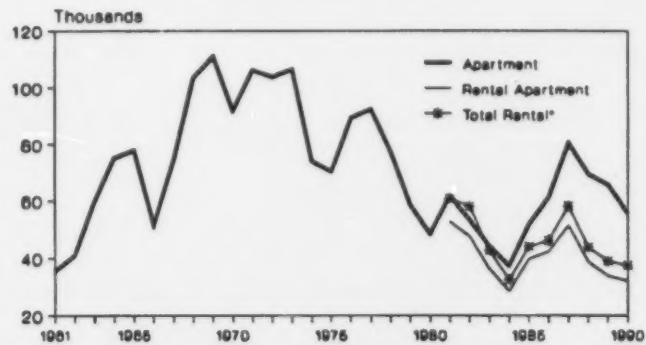
Aggregate additions to the stock of rental housing consist of both the construction of new rental projects (conventional sources) and the creation of rental units from within the existing dwelling stock (non-conventional sources, such as the creation of secondary suites or shifts to rental tenure of new or existing condominiums and single-detached homes). No reliable data series exists which adequately measures additions to the rental stock from all these sources, although less complete information is available from a variety of sources.²⁴

One source of potential information is CMHC data on starts by tenure in urban centres of at least 10,000 population. This series, however, is only available since 1981 at the national level. As well, the series measures *intended* market, not necessarily *actual* tenure of the unit. For example, units in a building being marketed as condominium would all be recorded as condominium starts. However, a large proportion of these units may actually end up on the rental market, as investors purchase them to rent out as an investment.

Another source of estimates of rental production is provided by the Census of Canada data on growth in renter households. This source accounts for production not only of projects intended specifically for the rental market, but all dwellings that are in fact rented, regardless of dwelling type or initial tenure. Unfortunately, this source

24 For a discussion of the problems of measuring rental construction, see Clayton Research Associates, *Rental Housing in Canada Under Rent Control and Decontrol Scenarios, 1985-1991*, a study prepared for the Canadian Home Builders' Association, 1984.

EXHIBIT 3-1
RENTAL PRODUCTION AS ESTIMATED BY
STARTS, CANADA, 1961-1990



* Includes row
Source: CMHC and estimates by Clayton Research Associates.

of information is only available for aggregate five year periods (i.e. net additions from one Census date to the next).

Because of the complications in measuring actual total rental production, total apartment starts (or completions) are often used as a proxy. Consistent data are available back to the 1940s, therefore they can be used to measure the broad trends in rental construction over long time periods. However apartment starts suffer from two limitations as a measure of rental construction activity: 1) not all new rental units are apartments and 2) not all newly-built apartments are renter-occupied.

3.1.2 Conventional Rental Production Has Fallen Off Substantially Since the Mid 1970s

Conventional rental housing production in Canada, as measured by apartment starts, increased dramatically over the decade of the 1960s, from less than 50,000 units per year in the early years of the decade to over 110,000 units in 1969. Production then levelled off in the early 1970s (to an average of roughly 100,000 units per year in 1970-1973), before declining in the middle of the decade (to the 70,000-75,000 unit range in 1974-1975). A partial recovery occurred in 1976-1977 (to the 90,000 unit range) before apartment starts declined significantly and continuously near the end of the 1970s and into the first half of the 1980s (with the exception of moderate increases in 1981 and 1982).²⁵

Aggregate apartment starts data suggest that conventional rental production picked up substantially again towards the end of the 1980s. However, more detailed information on starts by intended tenure, available since 1981, indicate that rental starts did not increase as significantly. Rental apartment starts as well as total rental starts in the latter 1980s increased somewhat from the lows recorded in 1984, but remained relatively low - the increase in total apartment starts was in large part due to increased condominium apartment activity.

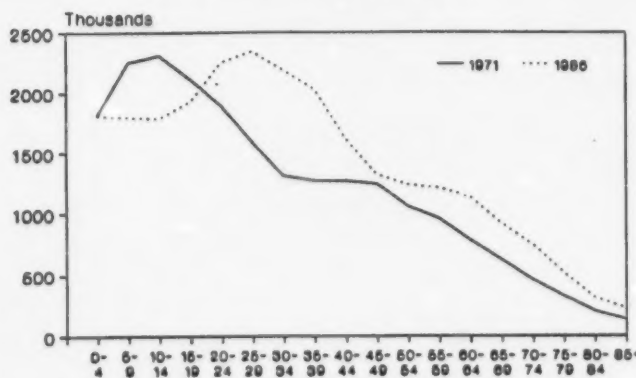
3.1.3 But Conventional Construction is Not the Only Source of New Rental Supply

Non-conventional sources of new rental supply are difficult, if not impossible, to measure accurately. Rough estimates of the current production from this source are provided for the primary centres under consideration in this study (Montreal and Vancouver) in Chapters 5 and 6; no attempt, however, is made to do so at the Canada level.

The amount of supply forthcoming from non-conventional sources can vary substantially from one period to another, based on underlying rental (and ownership) market conditions. As well, there is less permanency in this stock than is the case for conventional rental housing, due to the fluid nature of the supply (e.g. singles and

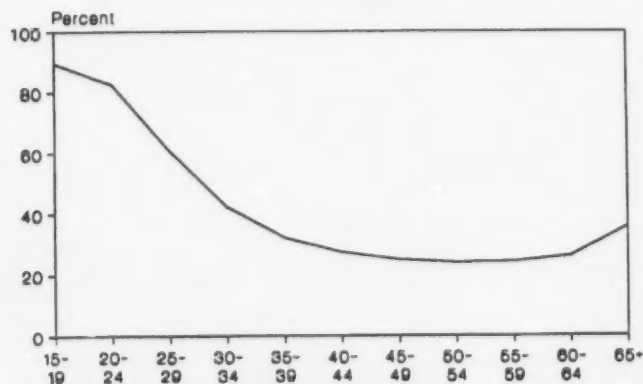
25 The reasons behind this pattern of starts are examined in Section 3.4.

EXHIBIT 3-2 AGE STRUCTURE OF THE POPULATION CANADA, 1971 AND 1986



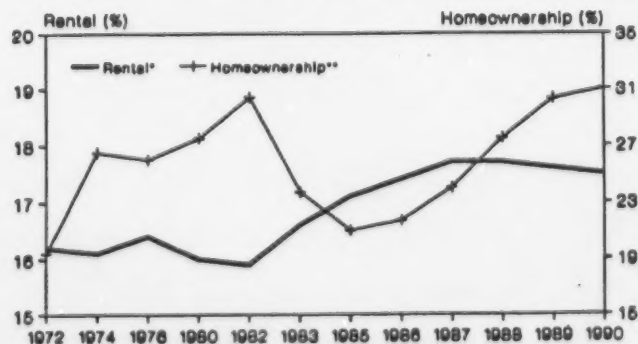
Source: Clayton Research Associates based on Census of Canada.

EXHIBIT 3-3 AGE SPECIFIC RENTER PROPENSITIES CANADA, 1986



* Renter households as a percent of all households.
Source: Clayton Research Associates based on Census of Canada.

EXHIBIT 3-4 RENTAL AND HOMEOWNERSHIP AFFORDABILITY CANADA, 1972-1990



* Annualized cash rent as percent of income in previous year.
** Mortgage payment on average priced MLS home as percent of average family income.
Source: Clayton Research Associates based on data from Statistics Canada's HIFE file and the Canadian Real Estate Association.

condominiums being rented can easily be removed back to the ownership stock, and converted units can be "deconverted").

The relatively low levels of new conventional rental construction combined with increasing vacancy rates in Canada suggest that this source of rental supply may have become relatively more important in some areas in recent years.

3.2 FACTORS IMPACTING RENTAL HOUSING DEMAND

In Section 2.2, the demand for rental housing was said to be determined by both **underlying requirements**, based on demographic factors and the **willingness and ability** of households to enter the rental market, given prevailing rents. This section briefly reviews the key factors which helped to shape the demand for rental housing in Canada over the past two decades. The section is relatively cursory in nature because the emphasis of this study is on the supply side of the rental market.

3.2.1 Underlying Requirements

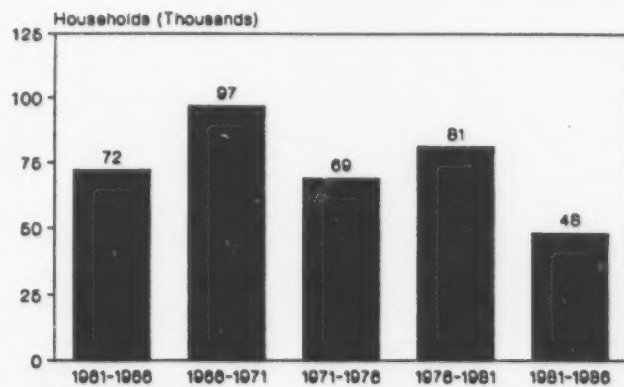
Underlying requirements for rental housing are shaped largely by the age structure of the population, the age-specific headship rates and the proportion of households in a given age group that are renters.

The aging of the leading edge of the baby boom population into the household-forming age groups occurred during the 1960s. Given the high ratio of renters traditionally in the younger age groups, this increased the underlying requirements for new housing. The pressure on the rental market from the baby boom generation then declined in the 1970s, as the baby boom generation started shifting into the age groups where they entered the ownership market. As the baby bust generation started to replace the baby boom generation in the prime household formation (and predominantly renter) age groups in the early 1980s, this signalled a reduction in underlying rental requirements.

3.2.2 Affordability of Rental Housing

Requirements for rental housing are translated into demand only if the desire and ability to rent is there. Affordability among renter households declined marginally in the mid 1970s, as increases in rents outpaced gains in income. After the widespread imposition of rent controls (discussed in more detail later in this chapter), affordability for renters improved until the early 1980s when it began a progressive deterioration. Since 1987, rental affordability appears to have more or less stabilized at the national level, although this would certainly not be the case for all individual centres in the country.

EXHIBIT 3-5
AVERAGE ANNUAL RENTAL HOUSEHOLD
GROWTH, CANADA, 1961-1986



Source: Census of Canada.

Part of the deterioration in renter affordability in the mid 1980s appears to have been due to a shifting of higher-income renters to ownership - taking these higher-income renters out of the rental base resulted in a reduction of overall average renter household incomes.

The analysis here concentrates on relative changes in rental affordability based on the percent of average income spent on average rent. This, of course, masks the fact that a significant proportion of renter households across Canada spend more than they can afford in rent.

3.2.3 Affordability of Homeownership

Because rental and ownership housing are substitutes (i.e. most households can in general choose either option), trends in the homeownership market impact a household's willingness to enter the rental market.

A major consideration in this regard is the relative affordability of homeownership. Affordability of homeownership is measured here as the proportion of income that is required to carry the mortgage and interest payments on an average-priced MLS home. Affordability of homeownership deteriorated during the 1972-1982 period, due to escalating house prices and interest rates. As prices and interest rates stabilized in the 1983-1986 period, the affordability of homeownership improved significantly and this resulted in an increase in demand for ownership housing. As noted above, this increase in demand for ownership housing was likely a significant factor in the deterioration in overall renter affordability indicated in Exhibit 3-4. Rising house prices and interest rates contributed to declining homeownership affordability since 1986.

A comparison of rental and homeownership affordability suggests that the attractiveness of renting relative to homeownership increased in the 1970s, declined in the early 1980s then improved somewhat again in recent years.

Affordability, however, is not the only measure of relative attractiveness of owning versus renting. Since homeownership involves an investment (and expectations of capital appreciation), as well as consumption of the services provided by ownership housing, there is also this aspect to consider.

3.2.4 Resulting Rental Demand

The demand for rental accommodation increased during the 1960s, as the leading edge of the baby boom generation had the desire and the ability to enter the rental market. Average renter household growth increased from about 37,000 per year in the 1950s to an average of 84,000 per year in the 1960s. Rental household growth then declined slightly to an average of about 75,000 per year in the 1970s, as the baby boom generation started to shift to the ownership market. In the early 1980s, renter household growth averaged only 48,000 per year, partially due to less

EXHIBIT 3-6
FEDERAL GOVERNMENT ASSISTANCE
FOR PRIVATE RENTAL CONSTRUCTION
1971-1990, UNITS*

	Loans to Limited Dividend Corporations	Assisted Rental Program	Canada Rental Supply Plan	Total
1971	11,059	-	-	11,059
1972	8,470	-	-	8,470
1973	4,311	-	-	4,311
1974	2,015	-	-	2,015
1975	10,150	21,792	-	31,942
1976	-	26,295	-	26,295
1977	-	57,044	-	57,044
1978	-	17,483	-	17,483
1979	-	-	-	0
1980	-	-	-	0
1981	-	-	-	0
1982	-	-	10,744	10,744
1983	-	-	10,265	10,265
1984	-	-	3,452	3,452
1985	-	-	-	0
1986	-	-	-	0
1987	-	-	-	0
1988	-	-	-	0
1989	-	-	-	0
1990	-	-	-	0

* Units approved in each year.
Source: CMHC

population in the prime household-forming (and mainly renting) younger age groups (the baby bust generation), but also due to weakened affordability during the recession years.

Comprehensive data for renter household growth since 1986 are not yet available, although the shifting age structure of the population, combined with the low level of rental construction implies that it has not recovered substantially from the low levels of the early 1980s. The deterioration in the relative affordability of homeownership versus renting has kept some potential homebuyers in the rental market (thus, increasing the demand for rental housing).

3.3 FACTORS IMPACTING RENTAL HOUSING SUPPLY

As noted in Chapter 2, the supply of new rental housing forthcoming at any point in time is impacted by the policies and programs of government and lenders, as well as the impact of trends in other parts of the real estate market. This section reviews major changes in these factors at the national level over the past two decades. Section 3.4 examines how these factors have combined to impact the level of rental housing production.

3.3.1 Government Policies and Programs

This section reviews government policies and programs which have impacted investment in rental housing in Canada.

3.3.1.1 Incentive programs for private investors

The following federal programs provided incentives for investment in private rental housing during the past two decades:

- **Loans to limited dividend corporations** - this program provided long-term, low interest rate loans to private groups who were prepared to limit the return on their equity to finance low-rent projects. The program was in operation in the 1946-1975 period, with the major thrust in the 1969-1975 period when loans were provided for over 63,000 units.
- **Assisted Rental Program (ARP)** - this program was introduced in late 1974 and operated until 1978 (a total of 122,614 units were subsidized). Developers of private market rental accommodation were given financial incentives (initially grants, but changed to interest-free loans for projects started later in the program) to build new rental housing. Benefits could be combined with MURB provisions (discussed in Section 3.3.1.4 under tax provisions), which provided tax shelters for individuals investing in rental housing.

EXHIBIT 3-7
FEDERAL GOVERNMENT SOCIALLY
ASSISTED NEW RENTAL HOUSING
1971-1990, UNITS*

	<u>Public Housing</u>	<u>Student Housing</u>	<u>Non-Profit and Coop</u>	<u>Total</u>
1971	21,244	732	3,109	25,085
1972	16,083	745	1,813	18,641
1973	13,429	108	1,207	14,744
1974	12,403	-	5,052	17,455
1975	13,354	-	5,008	18,362
1976	13,828	-	8,245	22,073
1977	6,763	-	4,562	11,325
1978	7,800	-	3,178	10,978
1979	1,601	-	4,721	6,322
1980	1,331	-	8,171	9,502
1981	1,367	-	11,780	13,147
1982	1,210	-	13,243	14,453
1983	1,299	-	12,695	13,994
1984	1,168	-	12,600	13,768
1985	947	-	15,600	16,547
1986	-	-	8,502	8,502
1987	-	-	14,576	14,576
1988	-	-	14,371	14,371
1989	-	-	9,947	9,947
1990	-	-	9,634	9,634

* Units approved in each year.
Source: CMHC

- **Canada Rental Supply Plan (CRSP)** - this program was introduced in late 1981 as a stimulus for new private market rental construction; it expired at the end of 1983 but was extended in a limited form to 1984. Private developers were provided with interest-free loans on which no payment was due for 15 years.

Since 1984, there have been no federal assistance programs for private rental construction.

Over the past two decades, there were a variety of provincially-sponsored rental incentive programs aimed at encouraging private investment in rental housing, but these were generally limited in scope.

3.3.1.2 Government supply

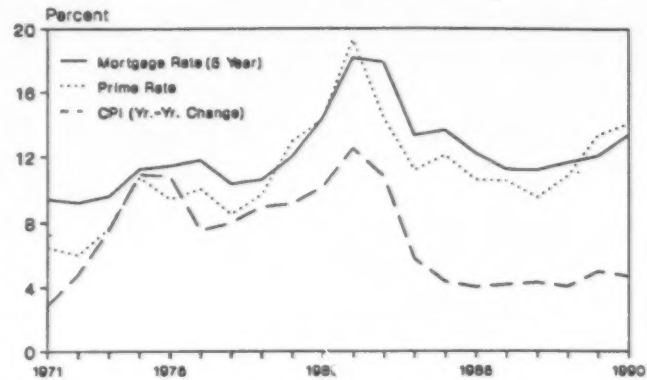
By definition, government supply does not directly impact the supply of private market rental housing, however, housing provided directly by the government (or through non-profit agencies) can have indirect impacts on private market housing, as discussed in Section 2.3.5.1. Government supply programs in operation over the past two decades include:

- **Public housing** - under various federal-provincial arrangements, each level of government shared capital costs and operating costs for public housing projects targeted at the needy. Activity under this program peaked in the early 1970s but was reduced to a nominal level by the late 1970s. The program has been inactive since 1985.
- **Student housing loans** - in the late 1960s and early 1970s, loans were available at below-market interest rates for student housing rental projects. Activity was never substantial under the program.
- **Loans to non-profit corporations and co-operatives** - these programs provide loans to non-profit corporations owned by a province, municipality or charitable corporation for the construction of low-rent housing. This program effectively replaced the public housing program as the main means of providing federal assistance to needy tenants during the early 1980s. The terms under which the assistance is provided have changed over the years from low-interest loans, to interest subsidies to 100 percent insured loans plus grants to offset operating losses.

3.3.1.3 Interest rate policies

Interest rates are generally set by the policies of the federal government - either through inaction (i.e. letting rates be determined in the marketplace without intervention), or by following specific interest rate policies. Higher real interest rates are a deterrent to rental investment.

EXHIBIT 3-8 INTEREST RATES AND INFLATION CANADA, 1971-1990



Source: Bank of Canada and Statistics Canada.

EXHIBIT 3-9 MAJOR TAX CHANGES IMPACTING RENTAL INVESTMENT: CAPITAL COST ALLOWANCE

Deductibility of CCA against other income

Overview:

- Allow depreciation to be treated as an expense for income tax purposes, at rates in excess of actual depreciation; CCA is recapturable when building is sold

History:

- Prior to 1972, all investors could deduct CCA against income from other sources
- After 1972 tax reform, only corporations in the business of real estate could deduct losses against other income
- In 1974, MURB provision reinstated for individuals and companies not in the business of real estate the ability to deduct CCA from other income; expired end of 1979; reinstated in 1980; ended finally end of 1981

Pooling of properties

Overview:

- Ability to pool rental properties to avoid recapture of CCA at sale of building

History:

- Prior to 1972, could avoid recapture of depreciation by pooling the recapture with CCA from other buildings
- After 1972, properties could no longer be pooled to avoid CCA recapture, for all taxpayers

Rate of depreciation

Overview:

- Rate of depreciation for CCA purposes higher than actual rate of depreciation
- Rate allowed has varied over time

History:

- Prior to 1978, the rate of depreciation was 10% for wood-frame buildings and 5% for concrete and steel reinforced
- In 1978, the rate for wood also set at 5%
- In 1987, the rate for both reduced to 4%
- In 1981, CCA limited to one-half of full-year amount in the year of completion
- In 1990, CCA commencement restricted to the year in which the building was "available" for rent

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Mortgage rates have followed the trends in the prime rate. Since the mid 1970s, real interest rates have been on a generally upward path. Five year nominal mortgage rates peaked in 1981 (at the 18 percent range, on average for the year), then gradually declined through to an average of 11.25 percent in 1986 and 1987 before beginning an upward rise again.

For the decade of the 1970s as a whole, nominal mortgage interest rates averaged roughly 10.5 percent. During the 1980s, the average mortgage interest rate was 13.5 percent (12.3 percent: if the 1980-1982 period is excluded).

3.3.1.4 Tax policies

This section deals with the major tax provisions relating to investment in rental housing which impact on the **income taxes** paid by the investor; commodity and property tax provisions impact the **costs** of building and operating a rental project, they are discussed in Section 3.3.3.

3.3.1.4.1 Capital cost allowance (CCA)

CCA deductions allow the treatment of depreciation on a building as an expense for income tax purposes - in most cases, these CCA deductions are in excess of actual depreciation. The CCA claimed on a building is subject to recapture as income when the building is sold if the sale price exceeds the depreciated value of the building. As such, the tax saved through the use of CCA can be accurately viewed as an interest free loan from the government until ultimate recapture when the project is sold. The use of CCA is a highly advantageous feature of rental investment and investors can minimize the negative features of depreciation recapture by timing the ultimate sale of the building such that it may fall in a year of low income from other sources.

Favourable CCA provisions for investors in rental buildings were a feature of most of the 1960s. These provisions allowed investors to treat CCA as an expense for income tax purposes (at rates in excess of actual depreciation) and to deduct the losses thereby "created" against income from other sources. This favourable tax treatment was not unique to rental housing, it covered all depreciable real estate.

As well, taxpayers with more than one income-producing property could defer recapture of CCA upon the sale of the building by pooling the recapture with CCA on the other properties.

Prior to tax reform in 1972, all investors in rental housing, as well as other types of income-producing real estate, were able to take advantage of these favourable tax treatments. With tax reform, however, the ability to "create" losses due to CCA and reduce income from other sources was restricted to corporations in the business of real estate, specifically life insurance companies and corporations whose principal business was the leasing, rental, development or sale of real property. Individual investors and non-real estate companies could no longer deduct CCA losses on any

EXHIBIT 3-10
MAJOR TAX CHANGES
IMPACTING RENTAL INVESTMENT:
DEDUCTIBILITY OF SOFT COSTS

Overview:

- Selected first-time costs incurred by owners of rental property can be deducted from rental income or income from other sources

History:

- Prior to 1979, soft costs could be deducted as paid, regardless of the period they related to; now can only be deducted in period to which they relate
- In 1981, the types of soft costs allowable were restricted. Allowable costs for those not in the business of real estate now only include mortgage, legal, appraisal and accounting fees, landscaping costs, promotion and advertising, and pre-opening and start-up costs; other costs previously allowed such as construction, architects' fees, building permits must be capitalized into the value of the building and depreciated over time

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real estate against income from other sources; CCA could still be used to offset income from the property itself - it could no longer be used to "create" a loss. In addition, tax reform eliminated pooling of most types of properties to avoid recapture of CCA for all taxpayers.

In late 1974, the Minister of Finance re-introduced, on a temporary basis, the tax deductibility of CCA on new rental residential buildings from other income for individuals and non-real estate corporations under the Multiple Unit Residential Building (MURB) provision of the **Income Tax Act**. This resulted in a large number of syndications of new rental projects to investors wishing to take advantage of the MURB tax shelter. The MURB provision was allowed to expire at the end of 1979; it was reinstated in 1980 but finally expired at the end of 1981. Therefore, CCA write-offs were available to all investors in new rental housing throughout the 1960s and up to 1981, with the exception of 1972-1974 and part of 1980.²⁶

Prior to 1978, the rate of depreciation for wood-frame buildings was 10 percent, compared to 5 percent for concrete and steel reinforced rental buildings. In 1978, the rate for wood-frame buildings was reduced to 5 percent as well. In 1987, the rate of CCA for all types of rental buildings was decreased to 4 percent.

On November 12, 1981 (January, 1, 1982 for MURBs), the "half-year" rule came into effect; under this rule, new rental buildings were limited to one-half of the regular full-year CCA in the year of completion. In 1990, the "available-for-use" rule was applied to new rental buildings; it restricted commencement of the use of CCA to the year in which the building was **available** for rent. The first year of use of CCA, as determined by the "available-for-use" rule, is also restricted in amount by the "half-year" rule.

3.3.1.4.2 Deductibility of soft costs

Soft costs (or first-time costs) are expenditures incurred by the owner of a new rental property which are not related to the actual acquisition of the fixed assets, i.e., the land, building and equipment. Allowable soft costs can either be deducted from income from the project in calculating tax, or in the case where there is already a loss on the property, the soft costs can be deducted against income from other sources in calculating income tax.

Prior to 1979, soft costs could be deducted as paid, regardless of the period to which they related. In 1979, this was changed such that soft costs could only be deducted in the year to which they relate.

The soft costs allowed for deductions on real estate projects have been severely restricted in the period since 1981. Currently, for all taxpayers, allowable soft costs

26 In 1987, the federal government announced that the investors in the existing MURB projects would no longer be allowed to deduct CCA losses from these buildings against other income starting in 1994.

EXHIBIT 3-11

**MAJOR TAX CHANGES
IMPACTING RENTAL INVESTMENT:
TREATMENT OF CAPITAL GAINS**

Overview:

- Treatment of capital gains for income tax purposes has varied

History:

- Prior to 1972, capital gains were not taxable
- Beginning 1972, 50 percent of capital gains were to be included in income for tax purposes
- In 1985, introduction of a lifetime exemption which increased from \$20,000 in 1985 to \$100,000 in 1987
- In 1987, 50% ratio of capital gains to be included in income was revised upwards to 75% by 1990.

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include the costs of borrowing money such as various types of mortgage fees and legal, appraisal and accounting fees, landscaping costs, promotion and advertising and pre-opening and start up costs. Some of the soft costs which were previously allowed to be deducted by all taxpayers, but are now restricted only to companies in the business of real estate include interest and property taxes during construction, architects' fees and, building permits. For companies not primarily in the business of real estate, these costs must now be capitalized into the value of the building, and depreciated over time.

Soft costs were an important tax shelter for rental projects syndicated to individual investors during the MURB years. Though restricted more, they continue to be used in rental tax shelters today. See Section 3.3.1.4.5.

3.3.1.4.3 Rental losses from expenses and mortgage interest

As a general rule, losses on any rental property can be deducted from income from other sources in order to compute income for tax purposes. Such losses could (and, for new buildings, generally do) result from a situation where rental revenues are insufficient to cover the out-of-pocket expenses associated with the project (e.g. operating costs and mortgage interest payments) but **not** depreciation on the building. This has been an on-going tax feature.

3.3.1.4.4 Treatment of capital gains

Prior to the 1972 tax reform, capital gains on rental property were not taxable; following 1972, 50 percent of capital gains from rental property were included in income for tax purposes.

In 1985, the lifetime capital gains exemption for individuals was introduced. At the time the intent was to gradually raise the limits from an initial \$20,000 to \$500,000 by 1990. The level, however, was capped at \$100,000 in 1987; also at the time, the proportion of capital gain to be included in income was increased from 50 percent to 66% percent in 1988, then up to 75 percent in 1990.

3.3.1.4.5 A note on syndications

Individuals have always been a source of investment funds for new rental housing. As discussed, before the income tax reforms of 1972, tax advantages were substantial for higher income individuals to invest in rental housing because of the liberal CCA provisions. Many rental apartment developers constructed projects, mainly small projects, for sale to individual high-income investors in this period.

With the introduction of MURBs in the mid 1970s, several companies began syndicating rental projects in packages for individual investors. Ownership could take the form of an undivided interest in a total project or the ownership of a

EXHIBIT 3-12

ILLUSTRATIVE SYNDICATED RENTAL BUILDING

(\$ per unit)

Project Cost

Capital Cost	
Land	5,825
Building and Equipment	71,065
Total Capital Cost	76,890
Syndication Costs	15,610
Total Project Cost	92,500

Project Financing:

Total Project Cost	92,500
Loans	
Property Loan	67,025
Equity Loan	25,475

Annual Project Revenues and Costs

	First Full Year	Fifth Full Year
Revenues	7,980	9,700
Operating Costs	2,795	3,395
Net Operating Income	5,185	6,305
Other Deductable Costs	2,865	520
Capital Cost Allowance	2,320	2,740
Net Income (for tax purposes)	0	3,045

Investor Revenues and Costs

Net Operating Income	5,185	6,305
Property Payment	(8,580)	(8,580)
Equity Loan Payment	(3,315)	(3,315)
Deficiency	(6,710)	(5,590)
Tax Reductions (46% Rate)	5,245	3,650
After-Tax Cash Flow	(1,465)	(1,940)
Cumulative After-Tax Cash Flow	(465)	(5,450)

Source: Clayton Research Associates.

particular condominium unit. The MURB syndicators often provided a variety of extras, such as cash flow guarantees and mortgage interest rate write-downs for fees that qualified for income tax deductions as soft costs and, in addition, investors could use CCA to "create" losses for deduction from income from other sources. The packages were designed to provide individual investors with large income tax write-offs in the initial years of the investment and, in the longer-term, the prospect of capital gains as rents in the projects rose.

The ending of the MURB provision in 1982 was only one of a series of changes in the tax laws which acted to reduce the attractiveness of rental tax shelter investments. Other changes have included:

- Soft costs which (as discussed in Section 3.3.1.4.2) were eligible to be written off early in the investment were progressively reduced; most such costs must now be capitalized into the depreciable base and written off through CCA.
- "At-risk" rules for limited partnerships such as syndicated rental projects were introduced in 1986. These restricted the losses which could be claimed by limited partners to the actual contributions made.
- "Cumulative net investment loss" rules were established in 1988. These limit the amount of net capital gains eligible for capital gains deductions if the taxpayer has losses from investments such as tax shelters. The rules have the effect of reducing the attractiveness of tax shelters which result in capital gains for investors.
- Reduced CCA for new buildings (as discussed in Section 3.3.1.4.1).

Despite these changes, syndications of rental projects continued throughout the 1980s. They enjoyed a resurgence in the second half of the 1980s (though not to the previous MURB-related scale) but syndication activity has dropped off recently.

To illustrate how the new (non-MURB) syndicated rental projects work, Exhibit 3-12 provides the financial details from an actual recently completed high-rise syndicated rental project. The financial details relate to the purchase by an individual investor of a typical two-bedroom (975 square foot) condominium unit in the project. Highlights of the syndication are provided below:

- **Project Cost** - the total project cost to the investor is \$92,500. This includes \$5,825 for land, \$71,065 for the building and equipment and \$15,610 in syndication costs. The latter includes the following:

- revenue guarantee:	\$3,130
- equity syndication fee:	\$9,150
- administrative services fee:	\$2,045
- initial lease-up fee:	\$1,285

For income tax purposes, investors spread the deductions for these over the period to which they apply: \$3,620 in the initial part year, \$2,865 in the first to fourth full years and \$520 in the fifth year.

- **Project Financing** - the project is financed entirely with loans which are taken out by the investor: a loan against the property at 12.5 percent and an equity loan at 12.75 percent secured by personal guarantees; both have 25 year amortization periods. The project is initially financed with a blanket mortgage which covers the whole project. Upon registration of the project as a condominium, this is fractured into separate loans for each investor's holdings - as will become evident, this is an important feature of this syndication which is not common to many other recent syndications.
- **Annual Project Revenues and Costs** - in the first full year, net operating income of \$5,185 is projected. Since the loans are individually held by the investors, the project utilizes both deductible costs (fees for the revenue guarantee, etc. which were paid at the outset and financed with loans) **plus CCA** to reduce net income (for tax purposes) to zero. This is extremely advantageous to the investor since it allows for the use of CCA **before** the interest deductions are made from net income. If the loans were held as mortgages on the project, such deductions would not be allowed.

By the fifth full year, the deductible costs are much lower and CCA alone is insufficient to bring projected revenues to zero. The projected revenues assume an annual increase in rents of 5 percent which seems unlikely given the current oversupply in the rental market in which the project is located.

- **Investor Revenues and Costs** - net income less the investor's loan repayments generates a negative cash flow of \$6,710 in the first year; by the fifth year, this is reduced to \$5,590, according to the project pro forma. The investor's tax deductions consist of interest payments (less any net income from the project - positive by the fifth year). The after-tax cash flow for the investor is a negative \$1,465 in the first full year rising to a negative \$1,940 by the fifth full year.

The investor also owns the unit for two months prior to the first full year and, because of the substantial deductions for the syndication costs and little net income (because it is only a partial year), there are substantial deductions from income taxes for the investor in this initial year - one of the key selling points of the tax shelter investment. These are not shown on the chart, however, they amount to tax savings (at the 46 percent tax bracket) of \$2,160 per unit in that year. In total, the investor nets \$1,000 after taxes in the first year according to the pro forma.

After five full years (plus two months), the investor's cumulative after-tax negative cash flow (assuming rents rise as projected) is projected to be \$5,450. Thus, in addition to the return of all tax savings realized as a result of the deductions of the losses created by this project (\$26,450 according to

the pro forma), the investors must contribute a total of \$5,450 from their own funds.

After reviewing the performance of the project, it is considered unlikely to meet its revenue projections. There was a shortfall in the revenue generated in the first year which was offset by drawing on the revenue guarantee fund (the maximum withdrawals from this fund are \$3,130 per unit). Vacancies are currently 15-20 percent with rents lower than projected. It is likely that investors will be required to contribute more than indicated in the pro forma to keep the project financed.

This is only one example of a syndication. The specific provisions of other syndications can vary significantly from this example. In particular, the innovative use of CCA in this example is a relatively new phenomenon in rental project syndications in Canada. Other projects utilize a variety of other mechanisms to make their investments attractive to high-income investors. One common method is to use cash flow loans which are made to investors to offset negative cash flow in the early years of the project - these cash flow loans are repaid to the syndicator after a given period (generally five years) based on an assumed refinancing of the project to recognize the projected increase in value of the project by that point.

The performance of these projects has been mixed. Many have been successful and have proven to be a sound investment. Others have been less successful as projected rents (and expected increases in property value) have not been realized. Several syndicated rental projects have failed in recent years and have been repossessed by the mortgage lenders. As long as there are high-income taxpayers who pay high marginal tax rates and who seek long-term investments, and regulations which allow syndicators to formulate packages based on rental projects which are attractive to these individuals, it appears that syndications will be an important part of the rental market.

3.3.1.5 Rent controls

By the end of 1975, rent controls were in effect in all provinces as part of the federal government's Anti-Inflation Program. The provisions of the individual provincial rent control programs varied substantially among provinces and have changed within provinces over time. The specifics of these programs are not dealt with in detail here.²⁷

All provinces except B.C. (where controls were phased out beginning in 1978 and expired in 1983), Alberta (expired 1980) and New Brunswick (expired 1985) still have some form of rent control in effect today.

27 A summary of rent control programs up to 1984 is provided in Clayton Research Associates, *Rental Housing in Canada Under Rent Control and Decontrol Scenarios, 1985-1991*, prepared for the Canadian Home Builders' Association, 1984.

3.3.1.6 Landlord/tenant legislation

Laws encompassing the rights and responsibilities of landlords and tenants vary from one province to another and will not be dealt with in detail here. However, it appears that, in general, these laws have become somewhat more complex and restrictive in terms of landlords' freedom of action since the mid 1970s.

3.3.1.7 Condominium conversions laws

Policies with regard to condominium conversion activity have generally fallen under the jurisdiction of municipalities; therefore, there are a wide variety of policies, and it is beyond the scope of this study to review them.²⁸

The restriction of conversions of rental buildings to condominiums was not a major issue until the mid 1970s. At that time, the introduction of rent controls caused many owners of rental property to consider conversions as a means of protecting their investments. Reacting to fears expressed about the potential loss of rental stock, many municipalities imposed restrictions on condominium conversions.²⁹ Particularly in areas where rent controls continue, therefore, there is continuing pressure for restriction of condominium conversions.

To get around the problem of restricted conversions, it is now common practice for rental investors to routinely register multiple buildings up-front as condominiums, even if they are initially intended as rental buildings.

3.3.1.8 Restrictive practices with regard to land approvals, development charges, required donations and building codes, etc.

These restrictions are generally imposed at the municipal level and therefore are subject to wide diversity - they are not, therefore, dealt with in any detail here.

There does, however, appear to have been a trend throughout Canada over the last few decades towards more complex approvals processes as well as increased utilization of development charges and donations required for development.³⁰ To the extent this is occurring, it has contributed to increasing development costs.

28 A review of condominium conversion policies in selected centres up to 1986 is provided in Clayton Research Associates, **Causes and Consequences of Condominium Conversions: A Policy Framework for the City of Toronto**, a study prepared for Clarkson Gordon, 1986.

29 Ibid, p. 2

30 Clayton Research Associates, **The Evolution of the Housing Production Process, 1946-1986**, Working Paper Two of **The Housing Industry: Perspective and Prospective**, a study prepared for Canada Mortgage and Housing Corporation, 1989, p. 46.

3.3.2 Lender Policies

Financing is crucial to the economics of rental investment. Over the past decade there has been an evolution of the policies and practices of lenders in their financing of rental housing. The major changes are summarized below:

- **Maximum loan** - in the 1970s, high-ratio insured loans on rental buildings could be obtained for up to 90 percent of the appraised value of the building. After the substantial losses suffered by mortgage insurers on high-ratio rental loans in the early 1980s, the maximum insured loan available on rental properties is currently 85 percent of value.
- **Positive cash flow** - after the experience of the early 1980s, lenders are reluctant to lend on rental projects with a negative cash flow as was prevalent in the 1970s. By restricting the size of the mortgage to an amount which can be covered by the net operating income of the rental project, this practice increases the initial equity required from the investor in financing the project - with consequent impacts on the rate of return. For large credit-worthy investors, lenders may bend the rules with respect to negative cash flow through the use of a letter of credit or some such guarantee.
- **Value of the project as condominium** - multiple unit projects are generally worth more as individual condominium units than as a rental property. Therefore, appraising a property as a condominium will yield a higher lending value. Since most new rental buildings are registered as condominiums in any case, this is a potential means of getting around the relatively low appraised values which result from using the income approach in valuing rental properties. In recent years, it has become a common practice to value new syndicated rental projects (where each unit is sold to individual investors) at their higher condominium value. However, rental projects which are not syndicated are generally valued using the income approach - even if the project has been registered as a condominium.

These changes in lenders' policies with regard to rental housing have had an impact on the attractiveness of rental investment. The reduction in maximum loan and the reluctance of lenders to advance loans which would create a negative cash flow substantially increase the amount of equity required on a rental project. In combination with the higher interest rates that have prevailed in the 1980s, this significantly reduces the amount which lenders are prepared to lend on a project with a given cash flow.

This is demonstrated in the hypothetical example in Exhibit 3-13 which shows the lending values which apply to a project with a net operating income of \$6,000 (before

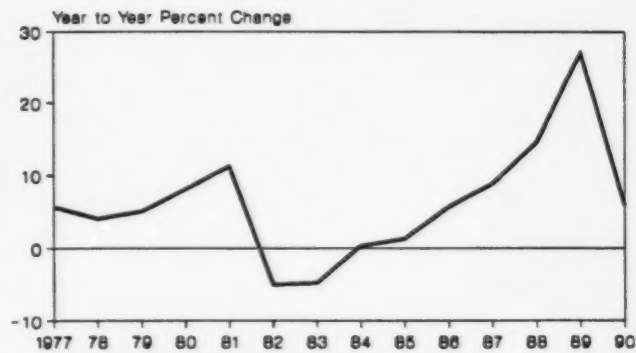
EXHIBIT 3-13

EFFECT OF INTEREST RATES ON MAXIMUM RENTAL LOAN DOLLARS

Net Operating Income	6,000	
Income for Debt Service (at 1.05 debt coverage ratio)	5,715	
	At 13% (Factor 0.1324)	At 10% (Factor 0.1074)
Maximum Loan	43,165	53,212

Source: Clayton Research Associates.

EXHIBIT 3-14 LAND PRICE INDEX* CANADA, 1977-1990



* The index measures for single-family land costs, comparable data for multiple land use are unavailable.

Source: Statistics Canada

debt service) using a debt coverage ratio of 1.05 (net operating income is equivalent to 105 percent of the mortgage payments).³¹

- At a 13 percent mortgage interest rate - the maximum mortgage loan is \$43,165.
- At a 10 percent mortgage interest rate - the maximum mortgage loan is \$53,212.

Therefore, the rise in interest rates from an average of roughly 10.5 percent in the 1970s to 13.5 percent in the 1980s and in 1990 (12.3 percent if the 1980-1982 period is excluded) had a significant impact on the amount which lenders were prepared to lend on rental housing. It is clear that the share of the cost of building a new rental unit which lenders were prepared to finance with mortgages was substantially reduced during the 1980s.

3.3.3 Real Estate Market Trends

This section reviews real estate market trends, particularly with respect to costs, which have impacted the viability of rental investment over the past two decades.

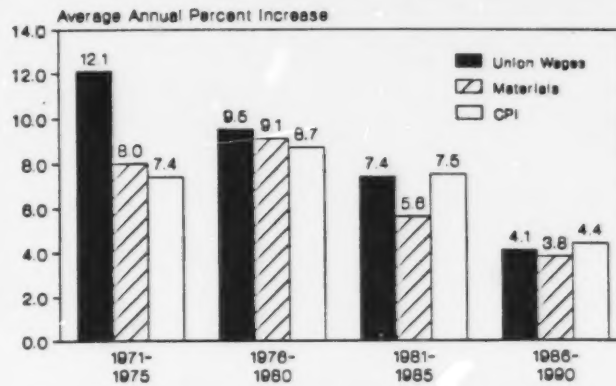
3.3.3.1 Land costs

Comprehensive information on land costs for rental construction on a Canada-wide basis are not available. However, the trend in land costs for new homes as shown by Statistics Canada's new housing land price index provides some indication of rising land values. These data indicate that land prices increased rapidly in the latter 1970s, before dropping and then levelling off in the early 1980s. Since 1985, land prices exhibited rapid increases, although the recent slowdown in the single-family markets has led to less rapid increases in 1990.

Land costs for rental housing have been particularly affected by the emergence of condominiums as an alternative (and, in some areas, highly competitive) source of demand for multiple housing land. In major centres such as Toronto, Montreal and Vancouver, the demand for condominiums has been a major consideration in the market for multiple housing land.

31 For non-insured loans, some lenders require a higher debt coverage ratio of 1.15 which would further reduce the maximum loan.

**EXHIBIT 3-15
RESIDENTIAL CONSTRUCTION COSTS
CANADA, 1971-1990**



Source: Clayton Research Associates based on Statistics Canada data.

**EXHIBIT 3-16
MANUFACTURERS SALES TAX
ON BUILDING MATERIALS**

	Building Materials	General Rate
	<i>Percent</i>	
Pre 1963	Exempt	Varied
1963-1964	4-8*	12
1965-1974	11	12
1976-1977	5	12
1978-1983	5	9
1984-1985	6	10
1986-1987	8	12
1988-June 1989	8	12
June 1989 - Dec. 1989	8	13.5
Jan. 1990 - Dec. 1990	9	13.5

* June, 1963 - March, 1964 at 4%; April 1964 to December 1964 at 8%.

Source: Clayton Research Associates based on Canadian Tax Foundation information.

3.3.3.2 Construction costs

The escalation in general inflation beginning in the mid 1970s was also reflected in rapid increases in construction costs (i.e. materials and labour). The more moderate inflation of recent years has also carried over to construction costs.

In relative terms, increases in material costs have on average been just above (1970s) or below (1980s) the rate of inflation. Construction wages (as measured by Statistics Canada's construction union wage rate index), however, increased much more rapidly in the early 1970s. Since the mid 1970s, construction union wage rate increases have been more in line with the general rate of inflation.

The cost of construction materials has been impacted over the years by periods of favourable federal sales tax treatment. Prior to 1963, most building materials were exempt from federal sales tax. From 1963-1974, most construction materials were taxed near the full sales tax rate. Building materials again received preferential treatment in 1974, when they were taxed at 5 percent, and have remained below the general rate, though at differing levels, in the period since.

The introduction of the GST in 1991 has added to development costs: new rental buildings are subject to the full 7 percent GST on their fair market value. As a result, rates of return for rental investors will be negatively impacted by the GST (unless there is a compensating increase in general market rents).

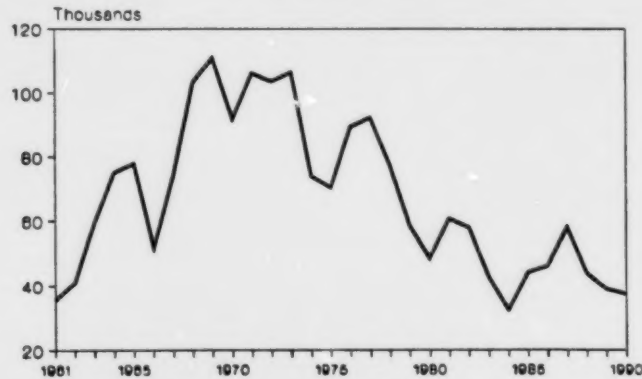
3.3.3.3 Other costs

Comprehensive historical information is not available on other costs such as maintenance and repairs and management costs, etc. but these have probably increased in line with overall inflation. To the extent that the GST will add to these costs, rates of return for rental investors will be negatively impacted (unless the higher costs can be passed through to tenants in rents).

3.3.3.4 Relative costs of homeownership

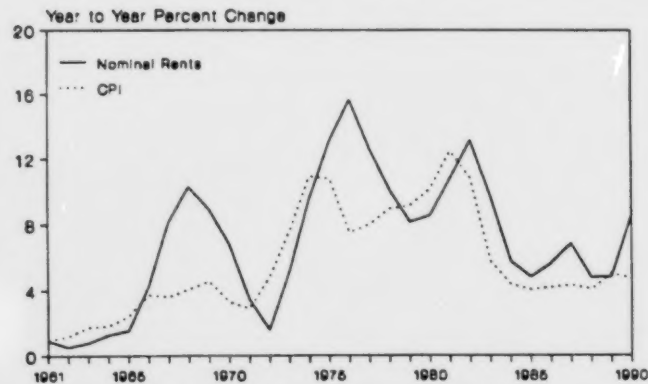
The demand impacts of the relative costs of homeownership were dealt with in section 3.2.3. In terms of the impact of homeownership costs as an incentive to rent out secondary suites (to assist with mortgage payments), the deterioration in homeownership affordability in recent years due to rising house costs (in some areas) and interest rates would certainly have made this more attractive.

**EXHIBIT 3-17
RENTAL STARTS*
CANADA, 1961-1990**



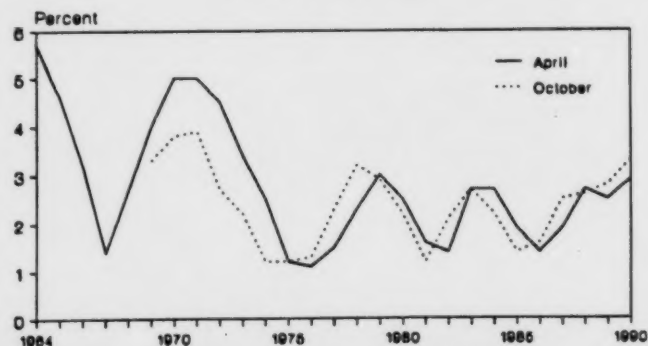
* Approximated by total apartment starts in 1961-1980.
Source: Clayton Research Associates based on CMHC data.

**EXHIBIT 3-18
RENTS AND INFLATION
CANADA, 1971-1990**



Source: Estimates by Clayton Research Associates based on Statistics Canada data.

**EXHIBIT 3-19
RENTAL APARTMENT VACANCY RATE*
CANADA, 1964-1990**



* Vacancy rate in privately initiated rental structures of 5 or more units excluding newly completed

** Data for 1964-1965 are for June and for 1969-1974 are for June and December.

Source: CMHC

3.4 HOW HAVE THESE FACTORS COMBINED TO IMPACT THE LEVEL OF RENTAL HOUSING PRODUCTION?

This section examines how the trends in the major factors identified previously in this chapter have combined to produce the variations in rental housing production.

3.4.1 The Period to the Mid 1970s

In response to increased demand pressures and declining vacancy rates as the baby boom generation started to enter the rental market, rental housing production increased significantly during the second half of the 1960s. On the supply side, the favourable depreciation provisions and rising real rent levels acted as a general stimulus to production levels. Federal assistance to rental housing, either by direct supply, or assistance to private investors, remained low during most of the period, but picked up substantially at the end of the decade.

Rental starts peaked at over 110,000 units in 1969 and remained high in the period to 1973. Vacancy rates rose from the low levels of the late 1960s and to about 5 percent in the early 1970s. Rents increased significantly in the late 1960s but levelled off in the early 1970s in response to the increase in vacancy rates.

By the mid 1970s, several factors combined to cause rental starts to decline and, ultimately, rents to increase:

- Construction costs increased significantly in response to inflationary pressures.
- Mortgage interest rates rose from the 7-9 percent range which prevailed for most of the 1960s to the 11-12 percent range in 1974-1975 (see Exhibit 3-8).
- The reform of the income tax system in 1972 made investment in rental property less attractive. Prior to that year, property owners were allowed to deduct CCA on rental properties from income from non-rental sources. With tax reform, only companies in the business of real estate could continue to claim depreciation against other income.

The rising costs put pressure on rents, while the tax changes acted to reduce the returns on rental investment. As a result, vacancy rates declined significantly and this further aggravated the pressure on rents.

3.4.2 The Mid 1970s to the Early 1980s

Public pressure for rent controls was stimulated by the rapidly rising rents. Rent controls were introduced in the provinces which did not already have them as a part of the Anti-Inflation Program in the mid 1970s and were in effect in all provinces by

the end of 1975. However, rent controls, by restricting the rate of rent increase, reduced the current and future rate of return on rental investment and, therefore, made it less attractive to many investors. Even if, as in some provinces, new buildings were exempt from controls, investors still had to operate in a market where prevailing rents were relatively low.

Governments recognized this and, in an attempt to restore the profitability of new private rental investment, the federal government introduced two major new initiatives in late 1974 and 1975:

- The Assisted Rental Program (ARP) which provided annual subsidies and later, interest-free loans, to rental developers; and
- The MURB provision of the **Income Tax Act**, which restored the capital costs allowance tax shelter for individual investors in new rental buildings started within a designated period. It is estimated that 195,000 MURB rental units were started between 1975 and 1981.³²

In addition, several provinces piggy-backed or launched separate rental assistance programs to spur rental construction at this time.

As a result of these initiatives, apartment starts surged in 1976 and 1977 and conditions in the rental market improved - rent increases moderated (at least partly also due to rent controls) and vacancy rates increased. The price of this improvement in rental markets was a significant direct (ARP) and indirect (MURB tax shelter) subsidy to rental investors; however, the underlying economics of rental investment continued to deteriorate. Interest rates increased in the late 1970s and market rents were not rising quickly enough in the inflationary environment of the time to make unsubsidized rental investment an attractive proposition.

The cost of the rental investment subsidies and their success in spurring rental starts and easing conditions in the rental market led to the progressive dismantling of the programs:

- In January, 1978, the capital cost allowance (CCA) on wood-frame MURBs was reduced from 10 percent annually to 5 percent annually;
- In May, 1978, the ARP subsidy was replaced by the graduated payment mortgage (GPM) which carried no subsidy;
- At the end of 1979, the MURB provision expired; and
- The rules on the use of soft costs in tax shelters were substantially tightened.

32 Clayton Research Associates, **Tax Expenditures - Housing**, prepared for Canada Mortgage and Housing Corporation, 1981, p. 17.

In combination with high vacancies and rising interest rates, the result of these changes was a dramatic decline in rental construction beginning in 1978. Prevailing and expected market rents were below the rents necessary to cover the costs of construction and financing and still provide an attractive return on equity to rental investors.

In response to the declining levels of rental starts and low vacancy rates, the MURB provision was re-introduced temporarily in late 1980 and was in effect until the end of 1981. This caused a flurry of rental starts in late 1981 and early 1982.³³ The MURB provision was replaced by the less expensive Canada Rental Supply Plan (CRSP) which provided interest-free loans to rental developers in 1982 and 1983. There have been no federal initiatives to assist private rental construction since that time.

3.4.3 Mid 1980s to 1990

Rental starts increased in the mid 1980s but remained well below the levels of the 1970s. Vacancy rates were relatively low, but there was also a decline in the demand for new rental apartments and townhouses for a variety of reasons:

- Demographic trends were less favourable to new rental demand - in particular, the movement of the baby bust generation (persons born in 1965 or later) into the (mainly renter) household forming age groups reduced the net increase in rental households.
- The recession of the early 1980s caused many people, particularly young renters, to double up, either because of actual unemployment or uncertainty with regard to future employment. Indeed, Census data shows that the propensity for younger persons to form households actually declined over the 1981 to 1986 period.
- Resistance to higher rents in new buildings - despite the MURB and CRSP subsidies, rents in newly-completed buildings were much higher than those in the older (largely rent controlled) stock.
- Availability of alternate housing forms - additional rental units were being made available within the existing stock. In particular, condominiums were being rented as investment properties and many homeowners created secondary suites which generally rented for less than new conventional rental units.

33 Any multiple unit building which was started in 1981 qualified as a MURB. However, since the definition of a start for the purposes of the program was somewhat different from official dwelling start definitions, a large number of MURBs were officially recorded as dwelling starts in 1982 (and some were even recorded as starts in early 1983). Work did not proceed beyond the early start stage on some of these buildings for a considerable period.



- Attraction of renters to the homeownership option - generally rising house prices and the economic upturn of the mid to late 1980s provided a strong stimulus to the ownership housing market in most parts of the country. As relatively high incomes (in terms of the income distribution of renter households) were required to purchase a home, the renters who purchased their first home in this period not only reduced the demand for rental housing but, in general, reduced the demand for the higher rent types of accommodation - the part of the market supplied mainly by new housing.

As a result of these factors, the demand (and production) of new conventional rental projects has been relatively low during the second half of the 1980s. Additional factors which have reduced the volume of new conventional rental housing in this period were the generally high interest rates, the more restrictive terms on lending for rental housing (no negative cash flow and reduced maximum loans), the loss or watering down of many of the tax incentives which characterized the MURB syndications in the late 1970s and early 1980s and the more restrictive rent controlled environment in some parts of the country. Also, developers in many of the major centres had the option of building new condominium buildings rather than rental housing - providing the market was there, condominiums were a way for developers to recoup their costs (plus profits) from a new development much more quickly than with rental housing.

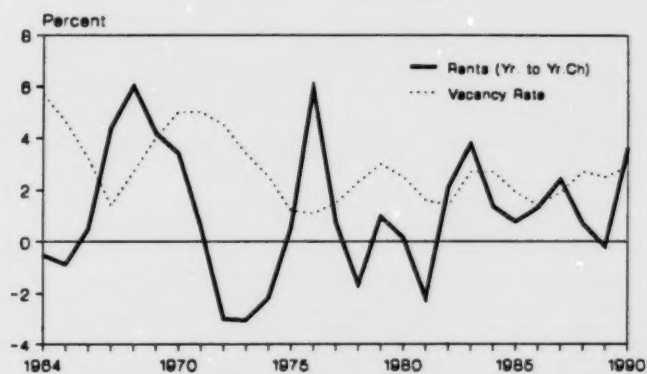
Much of the new private rental housing that was provided was through the syndicated tax shelter vehicle. Also, publicly-sponsored non-profit and co-operative housing has continued.

Finally, with the introduction of the \$100,000 capital gains exemption, the incentive for individuals to invest in rental housing has increased. This has been manifested in part by the investor purchases of tax shelters; however, it has also stimulated interest in investor owned condominiums and, to a lesser extent, houses in many major centres in the country. This new (non-conventional) source of rental supply, plus the secondary suites created by homeowners in their homes, has become an increasingly important component of the supply of rental housing in recent years.

3.4.4 Has the Rental Market in Canada Operated as "Theoretically" Expected?

According to the theoretical model presented in Section 2.1, there should be a relationship between real rents, vacancy rates and rental production. All other things being equal, it would be expected that when vacancy rates are low, there would be upward pressure on rents and that this would increase the attractiveness of rental investment and stimulate rental construction. According to theory, the new rental construction would, over time, result in an increase in vacancy rates which would moderate the pressure on rents - and perhaps result in lower increases or even a decline in rents in real terms. This, in turn, would reduce the attractiveness of rental investment which would result in a decline in new rental construction, which would ultimately result in a reduction of vacancy rates. And so on.

EXHIBIT 3-20
REAL RENTS AND VACANCY RATES
CANADA, 1964-1990



Source: Statistics Canada, CMHC and estimates by Clayton Research Associates.

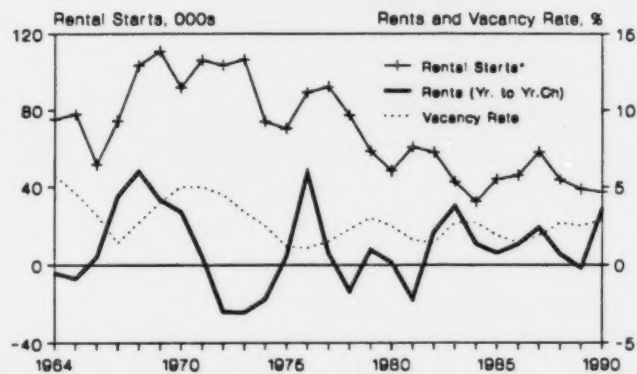
Of course, with all of the other changes in the external environment impacting the rental market (especially interest rate changes, economic cycles, changes in demand and changes in government policies and programs) over the years, it is to be expected that these relationships would not be clearcut. However, an examination of these relationships does appear to reveal a pattern generally consistent with the theory.

Exhibit 3-20 presents the trends in vacancy rates and real rents over the 1964-1990 period (1964 is the first year that the CMHC vacancy rate data are available). There appear to be four distinct cycles over the period.³⁴ Cycles are indicated by a movement from a peak of vacancy rates through a downward trend to a trough and back up to a peak - in theory, this should be mirrored by the opposite trend in real rents which, after a lag, stimulates new rental construction. Reviewing each cycle:

- **1964-1971** - At the beginning of the cycle, vacancy rates were comparatively high at 5.7 percent and, consistent with the theory, real rents were declining. By 1967, vacancy rates had dropped to only 1.4 percent and, in response to the tightening in the market, real rents increased significantly. These increases in real rents were followed by high levels of apartment construction in the period following 1967; this in turn led to an increase in vacancy rates to a peak of 5.0 percent in 1970 and 1971. Increases in real rents started to decline.
- **1971-1979** - From the peak in 1971, vacancy rates drifted downward over the remainder of the first half of the 1970s to 1.1 percent in April, 1976. Factors contributing to their decline were high levels of demand and a fall-off in rental construction due to tax reform and increased interest rates. The lower rent increases of the early 1970s were also a factor. Real rents declined by an average of 3 percent annually in the 1972-1974 period, but then escalated rapidly to a peak of about 6 percent due to the low vacancy rates. At this point, government intervention in the form of rent controls halted increases in real rents. Other government intervention, principally MURBs and ARPs, were instrumental in stimulating new rental construction, which led to an increase in vacancy rates to 3 percent in 1979. This vacancy peak was well below previous peaks.
- **1979-1983** - vacancy rates declined in 1980-1982 but real rent increases were negative or very weak; rental construction was low due to high interest rates and the weak economy though the MURB and CRSP programs had some impact. Real rents did begin to rise later in the period, in response to the declining vacancy rates, but they were insufficient to stimulate new rental construction in the high interest rate environment. Vacancy rates increased in 1983 due to increased new supply and the effect of the recession on demand.

34 The real rent data series was created by Clayton Research, based on nominal rent information from the Census of Canada and Statistics Canada's HIFE microdata information; real rents take into account the impact of inflation. The vacancy rates are CMHC's total CMAs vacancy rate in privately initiated rental buildings of 6 or more units, excluding newly completed.

**EXHIBIT 3-21
REAL RENTS, VACANCY RATES AND
RENTAL STARTS, CANADA, 1964-1990**



* Approximated by apartment starts in 1964-1980.
Source: Statistics Canada, CMHC and estimates by
Clayton Research Associates

- **1984-1990** - the interrelationship between vacancy rates and real rent increases appears to be no longer as clear-cut as in the first two cycles, nor even the third. Vacancy rates reached a cyclical low in 1986; although there was some response on the part of real rents in 1987, it was not as pronounced as in earlier cycles. Increases in real rents fell in the 1987-1989 period; at the same time, higher interest rates added to the costs of rental investment. It is not surprising, therefore, that rental construction remained low. Vacancy rates continued to rise, despite the declines in real rents and lack of new rental construction - non-conventional supply is likely a factor here.

It appears that real rents increased in 1990 despite continuing high vacancy rates. This degree of rent increase is unlikely to be repeated as long as vacancy rates continue at recent levels.

Exhibit 3-21 presents the same vacancy rate and real rent data as Exhibit 3-20 but with the addition of data on rental starts.

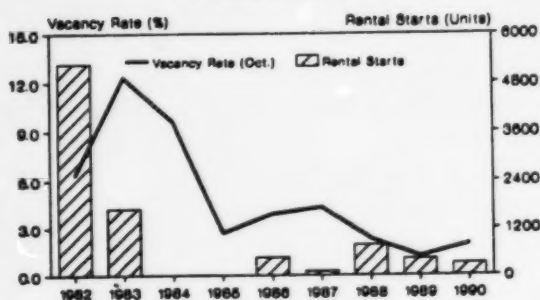
It would appear then that the rental market was reacting **broadly** as expected (allowing for intervention from outside forces) until the late 1970s, when the **fluctuations** in vacancy rates and rent increases became less pronounced and so too the relationship between these variables. The moderation in rent changes, of course, was at least partly due to the influence of rent controls.

The break in the relationship appears to have been that, although rent increases did accelerate, as expected, in 1982-83 and again in 1987 in response to declining vacancy rates, **they did not rise enough to stimulate new construction**. A number of factors are likely at play here including high interest rates, rent controls in some provinces and less attractive tax treatment of rental housing. The continuing increases in vacancy rates, despite declines in real rents and new construction, suggests that non-conventional supply plus a fall-off in demand (due to demographics and movement of renters to the ownership market) are having a major influence on the rental market.

3.5 SELECTION OF FIVE CENTRES FOR EXAMINATION IN STUDY

There is no **national** rental market per se in Canada. Rental markets like all housing markets are localized and are, therefore, subject to a variety of local and provincial influences that may not be common to all rental markets, and therefore, would be masked in an examination of national trends. To provide insights into the performance of actual rental housing markets, five centres were selected for further examination in this study: Calgary, London, Winnipeg, Montreal and Vancouver. These were chosen, by agreement of CMHC, BCHMC and the consultants, because their rental markets do not appear to conform to the theoretical operation of rental markets described in Chapter 2:

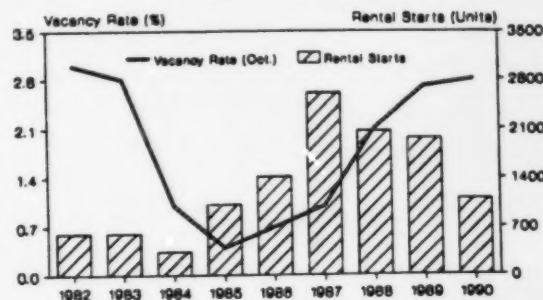
**EXHIBIT 3-22
RENTAL STARTS AND VACANCY RATES*
CALGARY, 1982-1990**



* Vacancy rate in rental apartment structures of 6 or more units excluding newly completed.

Source: CMHC

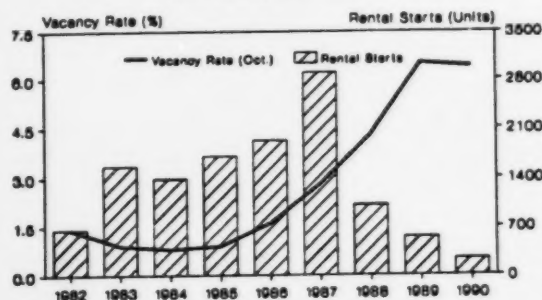
**EXHIBIT 3-23
RENTAL STARTS AND VACANCY RATES*
LONDON, 1982-1990**



* Vacancy rate in rental apartment structures of 6 or more units excluding newly completed.

Source: CMHC

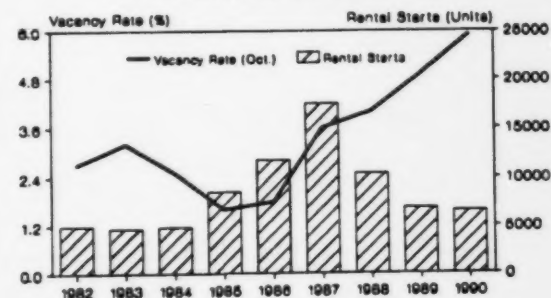
**EXHIBIT 3-24
RENTAL STARTS AND VACANCY RATES*
WINNIPEG, 1982-1990**



* Vacancy rate in rental apartment structures of 6 or more units excluding newly completed.

Source: CMHC

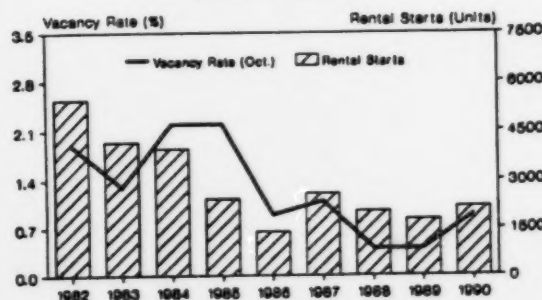
**EXHIBIT 3-25
RENTAL STARTS AND VACANCY RATES*
MONTREAL, 1982-1990**



* Vacancy rate in rental apartment structures of 6 or more units excluding newly completed.

Source: CMHC

**EXHIBIT 3-26
RENTAL STARTS AND VACANCY RATES*
VANCOUVER, 1982-1990**



* Vacancy rate in rental apartment structures of 6 or more units excluding newly completed.

Source: CMHC

- **Calgary**

Calgary is a market without rent controls, yet little rental construction has occurred in the 1984-1990 period, even though vacancy rates tightened in the last half of the 1980s and rents began to rise in the last few years.

- **London**

Ontario has rent controls, and most major Ontario centres have been plagued by very low vacancy rates due to low volumes of new rental construction. London, however, has had a considerable amount of rental construction in recent years and vacancy rates rose to the 3 percent range in 1990. Rental construction remained relatively high, however, despite the increased vacancy rates.

- **Winnipeg**

The Winnipeg rental market is also subject to rent controls. There was, however, a great deal of rental construction in the mid 1980s and vacancy rates began to rise. Although rental construction has fallen off dramatically in the last two years, vacancy rates continue to rise.

- **Montreal**

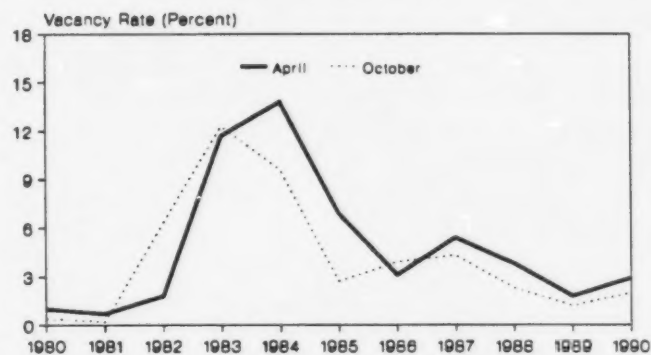
Montreal also has a form of rent control. Despite this, rental construction in Montreal increased substantially over the 1985-1987 period and vacancy rates have soared. Although some downward adjustment occurred in rental starts in 1988 and 1989, a larger number of units than could be absorbed by the market were built and vacancy rates have continued to rise.

- **Vancouver**

The Vancouver rental market is not subject to rent controls. Little rental construction has taken place that is not publicly initiated in recent years, despite declining vacancy rates and rising rents.

The reasons behind these apparent aberrations to the theoretical operation of the rental market are examined in the following three chapters. Chapter 4 presents an examination of trends in the Calgary, London and Winnipeg markets while Chapters 5 and 6 present a more indepth analysis of trends in Montreal and Vancouver, respectively.

EXHIBIT 4-1
RENTAL APARTMENT VACANCY RATE*
CALGARY, 1980-1990



* Vacancy rate in rental apartment structures of 6 or more units excluding newly completed.

Source: CMHC

CHAPTER 4

THE RENTAL MARKETS IN CALGARY, LONDON AND WINNIPEG

This chapter presents a review of recent trends in the rental markets in Calgary, London and Winnipeg with an analysis of the reasons behind the trends.³⁵ These three centres were selected for analysis along with Montreal and Vancouver because they do not appear to conform to the theory of rental market operation:

- **Calgary** is a market which does not have rent controls; the rental market has tightened from the experience of the mid 1980s and rents have risen, yet there has been relatively little new rental construction.
- **London** is a market which is subject to rent controls; there has been a considerable amount of new rental construction recently and vacancy rates are quite high.
- **Winnipeg** also has rent controls; as in London, there was a great deal of new rental construction in the 1983-1988 period and vacancy rates are high.

These apparent contradictions to the theoretical operation of rental markets are examined in this chapter. The analysis is based on an examination of trends in the rental markets in each centre gained through a consideration of available data and interviews with local government and industry officials.

4.1 ANALYSIS OF TRENDS IN THE CALGARY RENTAL MARKET

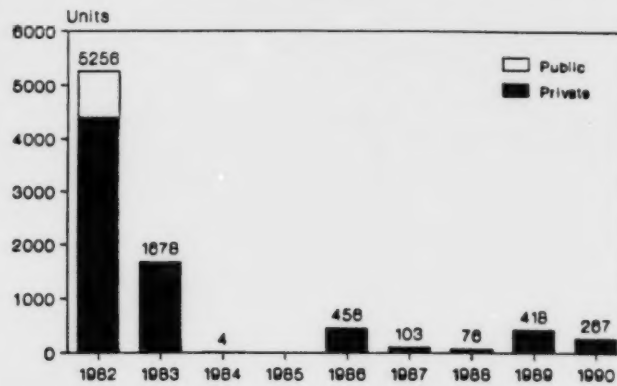
4.1.1 Market Recovering from Oversupply of Mid 1980s Significant Rent Increases, Reduced Vacancies But Little New Production

Calgary was devastated by the economic downturn of the early 1980s. After a period of strong economic growth during the last half of the 1970s resulting from the buoyant demand for energy, the City's economy was shaken by the recession and the decline in energy prices. The decline in the economy resulted in a heavy outmigration of population and a dramatic decline in housing prices.

The rental market in Calgary was severely affected by the virtual collapse of the City's economy. Vacancy rates soared to the 12-14 percent range in 1983 and early 1984, rents declined significantly and many rental apartment projects sustained substantial losses due to the unexpected decline in income. In many cases, lenders and the mortgage insurance companies foreclosed on rental properties with non-

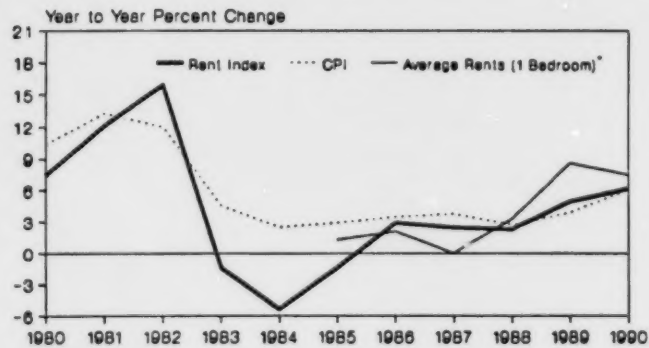
35 The analysis relates to the Census Metropolitan Areas (CMA) of these centres.

**EXHIBIT 4-2
RENTAL STARTS, CALGARY
1982-1990**



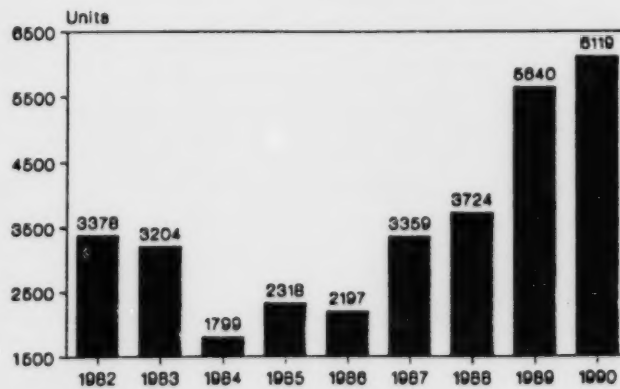
Source: CMHC

**EXHIBIT 4-3
RENTS AND INFLATION
CALGARY, 1980-1990**



* October rents
Source: Statistics Canada and CMHC.

**EXHIBIT 4-4
OWNER STARTS, CALGARY
1982-1990**



Source: CMHC

performing loans; in many others, work-out arrangements for the sharing of losses between both the lender and the owner were agreed upon.

Construction of new rental housing virtually ceased by the mid 1980s and there has been only a nominal amount of such new construction in the period since.

As the economy began to recover, the huge oversupply of rental housing began to ease. In the period since 1984, vacancy rates have fluctuated but generally declined to reach a low of 1.2 percent in October, 1989. Rents increased modestly during this period (after significant drops in the period prior to 1985) but generally did not keep up with inflation. In the period from 1985 to 1989, the rent component of the CPI increased each year by an average of only 2.2 percent annually compared to the overall average increase in CPI of 3.4 percent for the same period. It was not until 1989, according to the rent component of the consumer price index (as well as anecdotal evidence from observers), that rents in the City finally surpassed their 1982 level.

In 1990, there was an increase in the rental vacancy rate to 2.9 percent in April, 1990 - in October, 1990, the vacancy rate declined to 2.0 percent. A further rise in vacancies to 4.2 percent was recorded in April 1991. This rise in vacancies from 1989 to 1991 appears to be in response to several factors:

- An average increase in rents of roughly 8 percent in both 1989 and 1990 (in one-bedroom units) according to the CMHC Rental Market Survey - this was above the increase in the CPI (roughly 5 percent on average for the two years). The rent component of the CPI showed a lower (5 percent) increase in 1989 increasing to 6 percent in 1990. The increased vacancy rate suggests that this increase in rents may have encouraged the doubling up of many single renters.
- A general increase in confidence in the Calgary economy accompanied by a recovery in the new ownership housing market has led to many renters moving to the ownership market.

The higher vacancy rate was not due to completions of new rental buildings since a total of less than 700 new rental units were completed in 1989 and 1990.

4.1.2 The Question: Why are No New Rental Buildings Being Started When Calgary Has Rising Rents and No Rent Controls?

The Calgary rental market has not been subject to rent controls since 1980. There has been little new construction since the mid 1980s and rents have started to rise. Why have developers not responded by building new rental properties?

EXHIBIT 4-5

PRO FORMA OF RENTAL INVESTMENT, CALGARY (\$ per unit)

Project Cost

Land	10,000
Construction and Soft Costs and Profit	65,000
Total Project Cost	75,000

Project Financing:

Total Project Cost	75,000
Mortgage	56,250
Equity	18,750

Annual Revenues and Costs

	Year 1	Year 10*
Revenues		
Rental Income	9,420	13,410
Vacancy (3%)	(285)	(405)
Other Income	120	170
Gross Income	9,255	13,175
Operating Costs (Maintenance and Property Taxes)	3,000	4,270
Net Operating Income	6,255	8,905
Mortgage Payments		
Principal	340	1,050
Interest	7,105	6,390
Total	7,445	7,440
Net Income	(1,190)	1,465

* Income and operating costs assumed to increase at the rate of 4% per year.

** Mortgage rate of 13% over a 25 year term.

Source: Clayton Research Associates based on information from CMHC.

4.1.3 The Answer: Rents Rose But Not Enough to Make New Buildings Attractive

From an analysis of the economics of rental investment in Calgary (presented on the following pages), it appears that the rise in market rents was not sufficient to make new rental investment attractive to most investors given the prevailing interest rates. A small number of new rental properties have been built in the past few years; however, for the most part, the economics of new rental construction did not appear attractive to most developers and investors at that time. Also, the increase in vacancy rates indicates that renters are very sensitive to the rises in rents.

This conclusion is based on an analysis of the economics of new rental construction in Calgary presented next and examination of other potential reasons for the lack of new rental investment in the City.

4.1.4 Negative Cash Flow for New Rental Projects

The economics of building a typical new rental project in Calgary are summarized in Exhibit 4-5 which is based on information provided by the Calgary Office of CMHC in 1990 with some adjustments by Clayton Research. The project is a wood frame walk-up apartment with 30 suites with an average size of roughly 875 square feet of rentable space. Summarizing the results:

- The total project cost is \$75,000 per unit.
- Annual gross income in the initial year is \$9,255 (based on an average monthly rent of \$785 and allowing for vacancies and other sources of income).
- Operating costs and mortgage payments (assuming a 75 percent mortgage financed at 13 percent over 25 years) exceeds gross income and results in a negative cash flow of \$1,190 in the first year.³⁶
 - by the tenth year, there is projected to be a large positive cash flow (based on a 4 percent annual increase in rents and operating costs).

These broad costs were confirmed by discussions with several officials in the development industry in Calgary in 1990. For high-rise apartments, the land costs are generally lower, but the construction costs are higher - due mainly to the parking structure. In total, the development costs for a high-rise building are higher than those shown here for a low-rise building but the projected rents are not significantly different.

³⁶ The 13 percent mortgage rate was prevalent at the time this analysis was conducted. At 11 percent, the negative cash flow in the initial year is reduced to virtually zero.

EXHIBIT 4-6

PRO FORMA OF RENTAL INVESTMENT, CALGARY

	C-1	C-2	C-3	C-4	C-5
Project Type	Townhouse	Townhouse	High-Rise	High-Rise	Low-Rise
Unit Size (Sq. Ft.)	1,100	1,200	1,000	750	850
Interest Rate	11.25%	13.50%	13.00%	13.00%	11.50%
<u>Project Cost</u>			(\$ per unit)		
Land	10,000	12,500	7,500	N/A	N/A
Construction and Soft Costs and Profit	72,000	72,000	122,500	N/A	N/A
Total Project Cost	82,000	84,500	130,000	70,600	73,000
<u>Project Financing:</u>					
Total Project Cost	82,000	84,500	130,000	70,600	73,000
Mortgage	61,800	60,250	97,500	53,000	55,000
Equity	20,200	24,250	32,500	17,600	18,000
<u>Annual Revenues and Costs</u>					
Revenues					
Gross Income	9,400	10,880	14,875	8,150	9,400
Operating Costs	2,100	2,480	3,000	2,500	2,800
Net Operating Income	7,300	8,400	11,875	5,650	6,600
Mortgage Payments	6,950	8,000	12,075	7,000	6,580
Net Income	350	400	(200)	(1,350)	20

Source: Clayton Research Associates

To be attractive to developers, industry officials indicated that rents in the order of \$0.95 per square foot per month were required for new low-rise buildings (the CMHC example had rents of just below \$0.90 per square foot, a difference of 5.6 percent).

For high-rise buildings, which generally have higher costs and provide higher quality units, rents of \$1.05 and above were considered necessary to justify new construction. All officials contacted indicated that rents would need to rise in order to make new construction viable at the interest rates prevailing in 1990.

4.1.5 Several Possible New Rental Projects Shelved Recently in Calgary

Prior to the increase in interest rates in 1990, several projects were being actively promoted in Calgary in anticipation of a further reduction in the vacancy rate and further increases in rents. These were generally shelved due to a combination of factors including higher interest rates, resistance to rent increases and the higher vacancy rate for rental buildings.

Examples presented in Exhibit 4-6 of the financial details of actual and potential rental projects in Calgary bear out these conclusions. These examples were gathered through discussions with developers and have been rounded and changed marginally to protect the confidentiality of the developers who provided them; in some cases, estimates had to be utilized for information which was not available. Reviewing the salient financial details for each of the projects:

- Project C-1 - a rental townhouse project (with individual condominium titles) where the developer already owned the land but it had been vacant for many years with no potential buyers - a non-producing asset. The project was valued at a total of \$82,000 per unit. With a 75 percent mortgage (at 11.25 percent), the project generated a marginal (but positive) cash flow in the first year. The project was built and, following completion, was ultimately sold to a syndicator for \$86,500 per unit.

A key consideration in this project's economics was the fact that much of the equity was provided by a dormant asset - the land - with a zero opportunity cost. The remainder of the equity was mainly accounted for by the developer's profit. The project effectively turned a non-producing asset into a revenue-producing one for a minimal out-of-pocket investment. The sale to the syndicator was "icing on the cake".

- Project C-2 - another rental townhouse project similar to C-1 but with the critical differences being that the land was not owned by the developer and that interest rates had risen to 13.5 percent. This project did not proceed.

Interest rates were obviously a major factor in the decision not to proceed but the fact that a significant outlay was required to purchase the land was also of major importance. The rate of return on Project C-2 was insufficient



to justify the investment in terms of purchasing the land whereas if the land was effectively priced at zero (in terms of the outlay required from the developer), as in C-1, the economics would have been more attractive.

- Project C-3 - a large luxury high-rise rental project (with individual condominium titles). The average two-bedroom unit with 1,000 square feet and a projected monthly rent of \$1,200 is used here for illustrative purposes. These rents work out to \$1.20 per square foot per month. The proponent believed that the lack of good quality newer buildings in Calgary would allow the project to achieve these high rents.

On the original pro forma, the project commenced with a small negative cash flow (even at 13 percent interest rates) and the development appeared attractive. However, when quotes for construction costs were received, they were considerably higher than projected with the result that the profit from the project was no longer attractive. The project did not proceed. The land has been sold to other investors who may proceed with a different project.

- Project C-4 - a small high-rise rental building. The average one-bedroom unit with 750 square feet and a projected rent of \$700 per month is used here for illustrative purposes. The project generated a very considerable negative cash flow at 13 percent mortgage interest rates. At an 11 percent interest rate, the negative cash flow would be reduced to less than \$500 in the first year.

The project did not proceed but was still under consideration when the analysis was undertaken.

- Project C-5 - a low-rise rental apartment building. The average unit is used here for illustrative purposes. At 11.5 percent mortgage interest rates, the project generated a small positive cash flow in the first year. In this case, the land was owned by the developer and therefore the equity consists mainly of a non-producing asset plus the profit associated with developing the project. This project proceeded and was ultimately sold to an investor for roughly \$80,000 per unit.

This project would not probably have proceeded at 1990 interest rates. The fact that the developer could build it and expect it to cover the out-of-pocket costs (excluding land and profits) was likely a crucial factor in the decision to proceed.

There were several other rental projects under consideration by developers in Calgary prior to the increase in interest rates in 1990. Anecdotal information suggests that much of the land and plans for these potential projects had been sold to foreign (mainly Hong Kong) investors and/or were on hold awaiting a favourable lowering in interest rates or further increases in rents. Some developers, however, indicated that the introduction of the GST would have a significant negative impact on the economics of new rental projects.

EXHIBIT 4-7

PROJECT C-6 SYNDICATED EXISTING RENTAL BUILDING, CALGARY (\$ per unit)

Project Cost

Capital Cost	
Land	3,500
Building and Equipment	39,400
Renovations	6,750
Total Capital Cost	49,650
Syndication Costs	6,650
Total Project Cost	56,300

Project Financing

Total Project Cost	56,300
Mortgages	
First	9,110
Second (Investor held)	26,290
Cash plus Notes	20,900

<u>Annual Project Revenues and Costs</u>	<u>First Full Year</u>	<u>Fourth Year</u>
Revenues	6,510	8,160
Operating Costs	3,200	3,740
Net Operating Income	3,310	4,420
Mortgage Payments (First only)	1,030	1,030
Net Income	2,280	3,390
<u>Investor Revenues and Costs</u>		
Net Income	2,280	3,390
Adjustments	30	(70)
Distribution to Limited Partners	2,310	3,320
Limited Partner Debt Repayments		
Second Mortgage	2,310	3,000
Note Payments	2,960	2,580
Total	5,270	5,580
Deficiency	(2,960)	(2,260)
Income Tax Reduction	1,910	1,690
Net Deficiency After Tax	(1,050)	(570)

Source: Clayton Research Associates based on information from CMHC.

4.1.6 Extensive Turnover of Ownership in the Existing Rental Stock

There has been a great deal of interest in the Calgary rental stock in recent years and many buildings have changed hands. According to industry officials, many of the buildings were sold to Hong Kong investors but domestic investors have been active as well. In general, buildings have sold for capitalization rates of between 9 and 10 percent - i.e. the net operating income is roughly 9-10 percent of the selling price.

Many of the buildings sold were relatively old and sold for unit prices in the \$30,000-\$45,000 range. Prices of rental buildings increased significantly in the 1990; one observer indicated that the cash flow from a typical existing rental townhouse project which supported a price of roughly \$45,000 in 1988 would now support a price of roughly \$60,000 in 1990. Some newer projects sold for much more: one project recently built for a total cost (with profit) of \$85,000 per unit was sold to a Hong Kong syndicator for \$92,500; units were resold to investors for \$110,000.

A recent syndication of an existing building in Calgary provides some insights into both the prices in the resale market and the terms under which syndications are put together for investors. The project was a large high-rise apartment building. The financial details are summarized in Exhibit 4-7 - they have been adjusted from the prospectus to reflect the situation for an average suite in the complex. Highlights of the syndication are summarized below:

- **Project Cost** - the building was purchased by the syndicator in early 1989 for a price of just below \$36,000 per unit. The syndicator then obtained a valuation from a property appraisal firm which indicated an average value per suite of roughly \$43,000.

To upgrade the project, renovations totalling \$6,750 per unit were planned by the syndicator for a total capital cost of the project of \$49,650.

In addition to the capital cost, there were \$6,650 in costs associated with the syndication of the project; they included sales commission (\$2,100 per unit), services fees (\$2,500 per unit) and various other fees for legal, financing, etc. arrangements.

The total project cost of \$56,300 per unit was financed with an existing first mortgage of \$9,110 per unit, the investor's share of the second mortgage of (\$26,290) and cash plus promissory notes from the investor totalling \$20,900.³⁷ The investor paid a minimum of \$5,000 cash upfront with the remaining \$15,900 in promissory notes to be paid in installments (with interest) over a five year period.

37 The project includes a non-residential component as well as parking facilities. The share of the \$56,300 which was estimated to be for the dwelling units themselves was \$49,300.

- **Annual Project Revenues and Costs** - revenues for the first full year of operation (1990) were projected at \$6,510. This is based on an average rent of \$493 per month (plus some income from the non-residential component) - an increase of 11.4 percent from 1989 (due presumably to the improvements resulting from the renovation work).³⁸ A further increase of 10.3 percent was projected by the syndicator for 1991 followed by annual increases of slightly more than 5 percent per year.

Operating costs of \$3,200 were estimated for the first full year with annual increases of roughly 5 percent thereafter.

Net operating income was projected to rise from \$3,310 in the first year to \$4,420 in the fourth year.³⁹

Mortgage payments are relatively small (\$1,030 annually) because of the small first mortgage on the property. The main (second) mortgage financing is paid by the investor.

Net income was projected at \$2,280 for the first full year, rising to \$3,390 in the fourth year. However, this is before the main mortgage financing charges are considered.

- **Investor Revenues and Costs** - slight adjustments for administrative fees and other considerations make a minor change in the amounts that are projected to be distributed to the investors (described as the "limited partners"); the distributions are projected to total \$2,310 in the first full year and \$3,320 in the fourth year.

From these distributions and their own resources, the investors must pay their second mortgage (amortized over 25 years) as well as make payments on their notes.⁴⁰ These total \$2,310 and \$2,960, respectively in the first year.

The deficiency between the distribution and the debt repayments required from the investor was to be financed partly by the tax shelter aspect of the investment (providing \$1,910 in the first full year at a 47 percent marginal tax rate) with the remainder (\$1,050 projected for the first full year) to be financed out of the investor's own resources.

38 The revenue also includes rents from the non-residential part of the project. The actual performance of the project has been below expectations; revenues for the partial year prior to the first full year of operation were roughly 15 percent below projections.

39 The fourth year was selected for illustration because the pro forma does not go beyond five years and the fifth year expires partway through a calendar year.

40 The second mortgage payment increases over the period because the size of the mortgage increases from an initial advance of \$20,390 per unit with a further advance of \$5,900 when the project cash flow increases enough to support it - projected by the syndicator for 1991.

In total, over the first five years (in which the investor must pay off the full amount of the \$20,900 cash equity required), the accumulated net deficiency after tax (at the highest marginal tax rate and assuming all increases in rents are realized) was projected to total \$7,700. The remainder of the \$20,900 equity required from the investor, plus the interest on the notes, was projected to be financed mainly out of the tax shelter aspect of the investment (\$8,900) plus an assumed refinancing of the second mortgage at the end of the fifth year (an additional \$6,800). The refinancing would, of course, be dependant on the realization of the projected rent increases over the period.

This type of syndicated unit is sold mostly to Canadians because they can realize the tax benefits of the syndication. It is apparent, however, that many of the sales of existing rental apartments are being financed by off-shore syndications. In these cases, anecdotal information suggests that investors frequently contribute a substantial equity (up to 40-50 percent) to position the property so that rents will carry the operating and financing costs. These offshore investors apparently take a much longer view of property investment than local investors who, from experience, are less willing to invest substantial amounts of equity with little or no immediate return but possibilities of capital appreciation in the longer-term.

4.1.7 Rise in Rents, Lower Interest Rates Necessary for New Rental Construction in Calgary

The above analysis indicates that there was interest in investing in the Calgary rental market. Developers were examining the economics of building new rental projects and investors and syndicators were purchasing older existing buildings. The major problem appears to be that rents were below the levels necessary to make investment in new rental accommodation attractive - especially at the interest rates prevailing in 1990.

To conclude this analysis of the Calgary rental market, a review of the importance of each of the major factors influencing the attractiveness of new rental investment (identified in Chapter 2 of this study) is presented - with commentary on their applicability to the Calgary situation:

- **Government Incentive Programs** - these have not been a factor in the Calgary rental market for several years. Developers were divided as to whether they support their reintroduction; they could improve the economics of rental investment but most developers appear to believe that the market is best left to find its own level.

While incentives to subsidize rental housing have not been a factor in the Calgary market in recent years, government programs to assist homeowners may have been a factor in the decline in rental demand evident in the increasing rental apartment vacancy rates. These programs were the Alberta Mortgage Interest Shielding Program (which subsidized the interest

on first mortgages above 12 percent) and the Alberta Family First-Home Program (which provided \$4,000 in interest free loans to first-time buyers).

- **Government Supply** - this does not appear to have been a major factor in Calgary.
- **Interest Rates** - clearly, this was a critical factor in the decision of many rental investors not to proceed with planned new projects. Several developers had plans on the drawing boards which were abandoned due to the increase in interest rates in 1990.
- **Tax Policies** - no doubt the tightening of the tax shelter rules for rental investment in Canada have reduced the attractiveness of syndications in Calgary - as they have in other centres across Canada. However, syndications are occurring - mainly through sales of lower priced older buildings which will benefit from substantial capital gains if rents increase significantly. Current tax policies do not appear to be a major factor in the lack of new rental construction in Calgary though, clearly, more generous policies would improve the attractiveness of rental investment.
- **Rent Controls** - Calgary has not had rent controls since 1980, and there is apparently no fear among rental investors of their reintroduction in the future.
- **Landlord/Tenant Legislation** - current legislation was not considered by Calgary developers to be a significant factor in their decision not to proceed with new rental projects.
- **Condominium Conversion Legislation** - most new rental buildings built in Calgary have individually titled units and conversions of existing rental properties to condominiums have been occurring. In the first quarter of 1990, the City planning department received applications for conversions of 36 existing buildings to condominiums. By-laws, limiting conversions to cases where 75 percent of tenants approved, were passed in 1981 but have subsequently lapsed. The current policy appears to be a positive, not a negative, factor in encouraging new rental investment, because conversions reduce rental competition.
- **Restrictive Land Approvals Practices, Etc.** - there appear to be no problems in finding land for new rental construction in Calgary. However, some developers expressed fears that land supplies could tighten unless new supplies were forthcoming. Much of the multiple land was downzoned to lower-density use during the mid 1980s. Concerns were also expressed regarding difficulties in getting even properly zoned land through the City's approval process because of the public consultation process but these do not appear to have been a significant factor in the lack of new rental construction in Calgary.

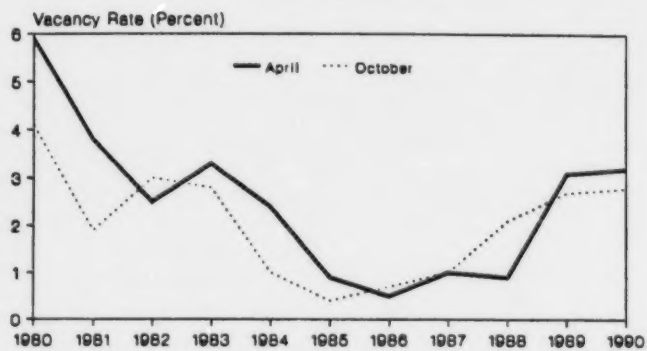
- **Lender Policies** - many observers indicated that lenders were very wary of lending in Calgary because of the experience of the mid 1980s. However, there was no evidence that lenders apply any more restrictive policies to rental loans in Calgary than they do in other parts of the country or that lender policies were a factor behind the lack of new rental construction in the City.
- **Real Estate Market Trends** - the cost of multiple land in Calgary is roughly the same as it was in the early 1980s and is not considered to be a major factor in the lack of economics of new rental construction. In particular, multiple land prices have not escalated in Calgary due to an upsurge in condominium starts activity as has been the case in Vancouver.

Construction costs have risen in recent years in response to the strengthening in the ownership housing market and the lower capacity of the industry following the migration of many workers out of Alberta during the recession. The rise in construction costs has been factor in the decisions of some developers not to proceed with new rental projects in Calgary. The rise in costs expected when the GST is introduced was noted by several developers as a reason for considering new rental projects in the early part of 1990 until the rise in interest rates.

The rise in vacancy rates in 1990 and 1991 following the progressive tightening of the rental market since the mid 1980s was not expected in Calgary. Despite only a small number of rental completions, vacancy rates rose after rents had increased above the level of inflation in both 1989 and 1990. The performance of the ownership housing market was likely an important factor here: with rising prices (and expectations of further rises in prices) after the dramatic drop in prices in the first half of the 1980s, potential homeowners were again looking at the market favourably - especially when rents started to rise. This could limit the extent of rent increases in the short-term.

In general, it appears that the decline in interest rates, coupled perhaps with a modest increase in rents, should be sufficient to stimulate new rental construction in Calgary when vacancy rates moderate. In 1990, at 11 percent interest rates, it appears that new rental townhouse projects would have been financially attractive to developers and investors and that low-rise apartment buildings were close to being attractive. The implementation of the GST will be a negative factor in the economics of new rental investment which will require an offsetting increase in rents or a further decline in interest rates.

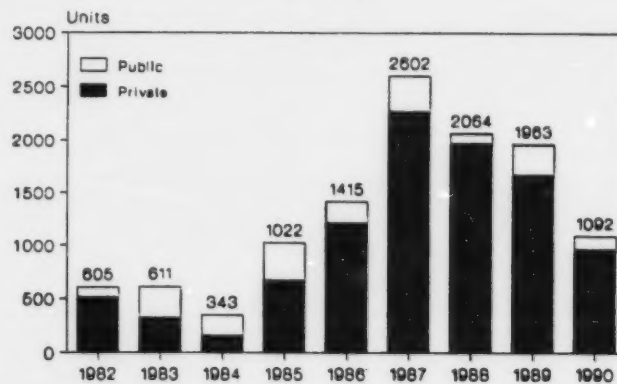
**EXHIBIT 4-8
RENTAL APARTMENT VACANCY RATE-
LONDON, 1980-1990**



* Vacancy rate in rental apartment structures of 6 or more units excluding newly completed.

Source: CMHC

**EXHIBIT 4-9
RENTAL STARTS, LONDON
1982-1990**



Source: CMHC

4.2 ANALYSIS OF TRENDS IN THE LONDON RENTAL MARKET

4.2.1 Large Number of Rental Starts Since the Mid 1980s, High Vacancy Rates, Rents Stagnant

Over the decade of the 1980s, the London rental market moved from an oversupply situation in the early part of the decade (almost a 6 percent vacancy rate in April, 1980) to a very tight market (a low of 0.4 percent in the mid 1980s) followed by a softening in the market to a vacancy rate of roughly 3 percent in 1989 and 1990. In April, 1991, the vacancy rate rose to 4 percent.

The trend in vacancy rates mirrored the production of rental housing in the City:

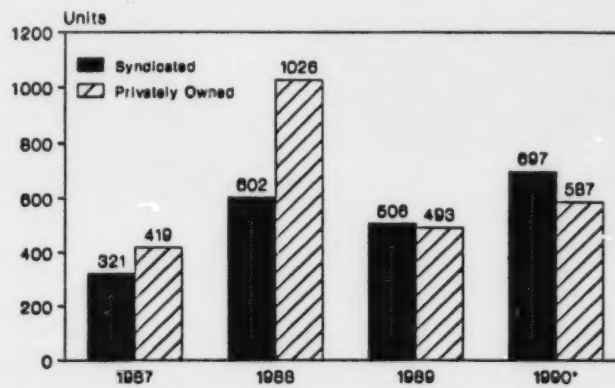
- In 1982-1984, rental housing starts averaged just over 500 units annually - a response to the high vacancy rates.
- In 1985-1986, an average of over 1,200 rental units were started per year in the City - vacancy rates were relatively low in this period and developers responded with increased rental production.
- In 1987-1989, rental starts exploded to an average of 2,200 units annually in London. In the early part of the period, vacancy rates were still low; however, many of these projects were started when the softening in the market was evident.
- In 1990, over 1,000 more rental units were started in the City.

This increase in rental activity occurred in a rent controlled environment with relatively modest average annual increases in rents. Over the 1984-1990 period, the average annual increase in rents for one-bedroom apartments in London was just over 5 percent annually. Discussions with knowledgeable industry officials indicated that rents were stagnant (in the newer stock) in 1990 with many of these projects suffering from very high vacancy rates.

4.2.2 The Question: Why Has New Rental Construction Been So High When London Has Rent Controls?

The London rental market has been subject to rent controls since 1975. The rents in all buildings completed at the time when rent controls were imposed became subject to controls while buildings completed after that date were exempt. In 1986, the controls were tightened to include rental buildings built since 1975 as well as any buildings completed subsequently. The developers of most of the newer buildings in London would have started construction in the knowledge that rent controls would apply to their building.

**EXHIBIT 4-10
COMPLETED SYNDICATED AND PRIVATELY OWNED
PROJECTS, LONDON, 1987-1990**



* January-September
Source: CMHC

Why would rental housing investors proceed with new construction when they knew the projects would be subject to rent controls?

4.2.3 The Answer: The Investors Expected to Earn a Competitive Return - Subsequent Events Have Proven Otherwise for Many

The following pages present an analysis of the economics of rental investment in London and the reasons behind the large number of rental housing projects built in the City over the past several years. To preview the analysis, it is clear that the projects were mainly of two types and that the ultimate investors made the decision to invest expecting a competitive return. The two main types of projects were:

- **Syndications** - an analysis of a selection of the rental projects completed in the 1987-1990 period undertaken by CMHC indicates that roughly 45 percent of the rental apartment completions in London in this period were syndications. As discussed earlier in this study, many developers have found a market for new (and existing) rental projects by syndicating them and selling them to investors. Though the tax shelter possibilities with syndications have been much reduced since the 1970s and early 1980s, they clearly were a major factor in the surge of activity in London.
- **Developers building projects for their own portfolio** - the remainder of the rental completions were mainly large London developers building projects to add to their existing portfolio of rental properties.

In both cases, the investors expected either a negative cash flow on their new investment or only a modest initial return. The main motivation was capital appreciation in the long-run. For syndicate investors, much of the investment required was projected to be provided by tax savings gained by sheltering income from other sources. For developers, any initial losses from the new projects were planned to be financed from existing cash flow from other real estate projects with all losses, including CCA, deductible from this other income.

Too many investors making the same decision, many of them apparently based on false premises, have resulted in an oversupply of new housing in London. Most of the vacancies are concentrated in the newer rental buildings which have much higher rents; the older stock has much lower rents and very low vacancies. As a result, the rents which are achievable on these new projects are generally well below the rents expected at the time the project was started.

4.2.4 Negative Cash Flow for New Rental Projects

The economics of building a typical new rental project in London are summarized in Exhibit 4-11 which was based on information provided by the London Office of CMHC in 1990 with some adjustments by Clayton Research. The project is a 90 unit mid-

EXHIBIT 4-11

PRO FORMA OF RENTAL INVESTMENT, LONDON

(\$ per unit)

Project Cost

Land	9,500
Construction and Soft Costs and Profit	63,000
Total Project Cost	72,500

Project Financing:

Total Project Cost	72,500
Mortgage	54,400
Equity	18,100

Annual Revenues and Costs

	Year 1	Year 10*
Revenues		
Rental Income	8,700	13,495
Vacancy (3%)	(435)	(675)
Other Income	480	745
Gross Income	8,745	13,565
Operating Costs	3,000	4,655
Net Operating Income	5,745	8,910
Mortgage Payments		
Principal	325	1,015
Interest	6,870	6,180
Total	7,195	7,195
Net Income	(1,450)	1,715

* Income and operating costs assumed to increase at the rate of 5% per year.

** Mortgage rate of 13% over a 25 year term.

Source: Clayton Research Associates based on information from CMHC.

rise building with an average unit size of 800 square feet of rentable space. Summarizing the results:

- The total project cost is \$72,500 per unit.
- Annual gross income in the initial year is \$8,745 (based on an average monthly rent of \$725).
- Operating costs and mortgage payments (assuming a 75 percent mortgage financed at 13 percent over 25 years) exceeds gross income and results in a substantial negative cash flow of almost \$1,500 in the first year.
- by the tenth year, there is projected to be a positive cash flow (based on a 5 percent annual increase in rents and operating costs).

A large factor in the poor economics of rental investment in London is the 13 percent mortgage interest rate which prevailed in 1990 - an 11 percent interest rate would reduce the negative cash flow by almost two-thirds.

4.2.5 Large Diversity in Performance of New Rental Projects in London

For most of the new rental projects built in London in the past few years, interest rates were lower than they were in 1990 and the projected returns appeared attractive to the investors. They are less attractive now with relatively stable (or declining) rents and increased vacancies in virtually all of the new projects. Examples are presented in Exhibit 4-12 of the financial details of several rental projects in London. These examples were gathered through discussions with developers and examination of prospectuses prepared by syndicators; completion dates are deliberately vague and financial details have been rounded and, in some cases, changed marginally to protect the confidentiality of those who provided them. Reviewing the salient financial details for each of the projects:

- Project L-1 - a high-rise rental project completed in 1986-1987 for a developer's own portfolio. The developer had owned the land for several years prior to construction and it appears that some of the project costs may not reflect actual market values at the time (e.g. the land or developer's profit). The project has a relatively small mortgage (only 65 percent of project cost) as the developer utilized cash on hand from other investments.

The revenue and cost figures shown in the Exhibit are 1990 figures; i.e. roughly three years following completion. In 1990, the project had a 7 percent vacancy rate and, as a result, was operating with a slight negative cash flow despite the large equity and low initial cost - vacancies, "rent allowances" and "special discounts" accounted for over 20 percent of the developer's projected potential gross revenues on this project. At a 3 percent

EXHIBIT 4-12

PRO FORMA OF RENTAL INVESTMENT, LONDON

	L-1	L-2	L-3	L-4	L-5
Project Type	High-Rise	Townhouse	High-Rise	Townhouse	Walk-Up
Unit Size (Sq. Ft.)	N/A	N/A	975	3-Bedroom	935
Interest Rate	11.00%	11.00%	12.50%	10.50%	10.50%
<u>Project Cost</u>			(\$ per unit)		
Land	N/A	N/A	5,825	N/A	9,500
Construction and Soft Costs and Profit	N/A	N/A	86,675	N/A	85,490
Total Project Cost	62,000	55,000	92,500	79,000	94,990
<u>Project Financing</u>					
Total Project Cost	62,000	55,000	92,500	79,000	94,990
Mortgage	40,750	48,000	67,025	71,100	71,240
Equity	21,250	7,000	25,475	7,900	23,750
<u>Annual Revenues and Costs</u>					
Revenues					
Gross Income	7,100	8,720	7,980	8,700	7,920
Operating Costs	2,500	2,050	2,795	2,460	3,825
Net Operating Income	4,600	6,670	5,185	6,240	4,095
Mortgage Payments	4,710	5,400	8,580	8,065	7,680
Net Income	(110)	1,270	(3,395)	(1,825)	(3,585)

Source: Clayton Research Associates

vacancy rate, the project would have generated a positive cash flow of over \$1,000 per unit.

- Project L-2 - a townhouse rental project also completed roughly three years previously by a developer for his own portfolio. Again, the costs provided by the developer appear low because they do not appear to take account of some of the profit and overhead on both the building and land development undertaken by the owner. That relatively low cost would explain the relatively large mortgage in relation to the developer's estimated cost shown in this example.⁴¹

The current year revenue and cost figures (i.e. three years following completion) indicate a substantial positive cash flow on the project. The reasons are that the project appears to have a relatively low mortgage in relation to the ultimate project value, an 11 percent mortgage rate and vacancies of only roughly 1 percent.

- Project L-3 - a high-rise syndicated rental project completed roughly two years previously. The financial details were derived from the prospectus; they include \$15,600 in fees etc. from syndication (including provision for a revenue guarantee fund). The information provided is based on a two-bedroom unit in the first full year of operation. The substantial negative cash flow projected to be generated by this project extends for several years into the future. It was attractive to investors because it generated substantial tax shelter advantages - the mortgage loans were taken individually by the investors. This allowed the use of CCA to offset the cash flow from the project prior to the deduction of interest costs. In effect, in the early years, for tax purposes, the project generated no cash flow at all (the excess of revenue over operating costs was offset, for tax purposes, by soft costs and CCA) but the investor could still deduct interest costs on both the project loan and other loans from income from other sources, thereby providing substantial tax shelter opportunities.

In fact, the performance of this project was disappointing for the investors. Revenues have had to be bolstered by an unspecified amount from the revenue guarantee fund set up by the promoter of the project to cover shortfalls - this fund could become exhausted in a few years. Rents appear to be lower than was indicated in the prospectus and the project was suffering from 15-20 percent vacancy rates in 1990. The annual 5 percent increase in rents projected in the prospectus seems highly optimistic. It seems likely that the investors could have to provide substantial additional funds to keep the project in operation in the future.

41 As is evident from the projects shown here, developers do not use a standard method of showing their costs. In some cases, it is actual out-of-pocket costs (including land at low or no value if it has been held for a long time); in others, costs are shown as "market value" in order to get the maximum mortgage or to show a high value for potential buyers/investors.

- Project L-4 - a townhouse project syndicated to investors and completed roughly two years previously. The financing of the project shown on the pro forma includes a second mortgage for 15 percent of the cost of the project. The investor obtained substantial soft cost write-offs in the initial year which largely offset the initial investment required. However, the tax write-offs in the following years were not projected to be sufficient to offset the negative cash flow - after allowing for contributions of all of their tax rebate, investors were required to continue to "feed" the project at least for the first five years. According to the pro forma analysis, at a 5 percent annual rate of increase in rents, the additional contribution required from an investor in the top tax bracket would be \$500-\$900 annually for the first five years.

In fact, rent increases have been below the projected levels and the project had some vacancies. For 1990, the rents were the same as for 1989 and this increased the amount which investors needed to provide to support the negative cash flow on the project.

- Project L-5 - a walk-up apartment complex syndicated to investors which commenced renting in 1989. The cost of this project was inflated by the addition of almost \$14,000 in various types of fees associated with the syndication; in return, the investors obtained substantial soft cost write-offs in the years prior to completion with a minimal initial investment. The negative cash flow on the project in the early years was offset by a cash flow loan from the developer repayable after three years when it is assumed that the project is refinanced for an addition to the mortgage of almost \$14,000 (this refinancing was justified on the assumption the property value will have increased by over 25 percent to \$120,000 per unit at this point due to 5 percent projected annual increases in rent). The project also includes a write-down of interest to an assumed 10.5 percent which is financed by the syndicator.

No information is available on how well the project is renting up, however, it seems likely that it may be experiencing some problems in the current rental market environment. No vacancy allowance was provided for in the initial years of the investment and rent increases of 5 percent annually were projected. It seems unlikely that the value of the property will increase sufficiently to justify the refinancing required to pay off the cash flow loan; in which case the investor will be liable for this.

These projects provide an illustrative cross-section of the types of projects that were built in London in the late 1980s. A number of developers built projects for their own portfolio. In general, these developers reduced the negative cash flow from their new projects by putting in a substantial equity in both cash (perhaps gained from refinancing an existing rental property that was generating positive cash flow or contributing land at below-market value or no cost if they have had it for a substantial period) and discounting of profits and overhead below what would normally be charged in an arm's length transaction. Virtually all of the developers building for their own portfolio already had a significant stock of rental buildings so

the infrastructure for maintaining and operating their stock was in place. While the returns in the early years were clearly inadequate to make the investment attractive to these developers, their experience indicated that, over the longer term, the returns from rental investment are substantial. Most observers indicated that it was unlikely that developers who were not already in the residential rental business would have built for their own portfolio in circumstances prevailing at that time.

Syndicators were also very active in the London market. Not only new buildings were syndicated; many developers sold older buildings from their portfolios to syndicators who sold the individual units to investors. In most of these cases, developers indicated that they obtained prices which were in excess of what they considered the buildings to be worth; they were, of course, resold to investors at substantially higher prices because of the various syndication fees, etc. The terms and qualities of the investments offered in projects that were built (or acquired) for syndication vary widely. A number of projects have already failed and are in the hands of the mortgage lenders; others are in difficulty with investors having to feed substantially more cash than planned to finance the investment; others are experiencing below-planned revenues but investors are being protected by the cash flow guarantee (which is limited to a fixed total sum in most cases); others are too new to tell how they will fare; some are doing well despite the current adverse market conditions - in some cases because the syndicator is contributing more than the prospectus required. In most cases, it appears that the revenue (and capital appreciation) projections on which the investors made their decision were too optimistic - investors are paying substantially more for their investment than they planned.⁴²

4.2.6 Expectations of Attractive Investment Return - the Reason Behind New Building in London

The London rental market was very active in the last half of the 1980s despite the existence of rent controls. Due to the high levels of new rental construction, the market is currently oversupplied and rents have stabilized and, in some cases, declined. The market is adjusting to the oversupply; little private rental housing is expected to be started for the next few years.

To conclude this analysis of the London rental market, a review of the importance of each of the major factors influencing the attractiveness of rental investment (identified in Chapter 2 of this study) is presented - with commentary on their applicability to the London situation:

42 London was the location of one of the syndicated rental developments financed by Standard Trust which subsequently resulted in substantial losses for the trust company. Masonville Estates, developed by Owl Developments of Edmonton, is a 332 unit apartment complex on which Standard Trust apparently advanced \$30.8 million (over \$90,000 per unit), according to an article in the Globe and Mail (November 12, 1990). The project is one of three tax shelter rental projects on which Standard Trust took a writedown of a total of over \$30 million, according to the article. Masonville Estates is not one of the projects used as examples of rental investment in this study.

- **Government Incentive Programs** - these have not been a factor in the London market for many years. In general, developers were not in favour of their introduction. A major reason why they were wary of such programs is that, in a rent controlled environment, by reducing initial rents, such programs also limit long-term returns. They would also encourage subsidized competition to existing newer (higher priced) rental properties which are bearing the brunt of the vacancies in London at present.
- **Government Supply** - this was not a significant factor in the new rental supply in London.
- **Interest Rates** - the relatively low interest rates that prevailed in the second half of the 1980s were a factor in the large number of new projects built in this period since many of the projects would not have been attractive at higher rates. The rise in interest rates in 1990 is not considered to be a significant factor in the reduction in new rental building since the softening market had already made new construction less attractive by this point.
- **Tax Policies** - a large share of the supply of new rental housing in London was due to syndications. These were projects specifically designed to appeal to high-income investors who wanted to shelter income from taxes by investing in a rental property that would generate losses for tax purposes. These losses, through deductions, would thereby generate much of the financing required for the investment. Without passing judgement on whether the investments represented good value for the investor, the tax shelter aspect was clearly very attractive to many investors. The deductibility of soft costs, the renewed use of CCA and a variety of other mechanisms were used by syndicators in London to present a projection of revenues, costs, tax savings and capital appreciation which were very attractive to many investors.

The tax shelter aspect of syndications, plus the ability of landlords to use CCA (and other losses) on newer buildings to offset taxes payable on the positive cash flow generated by older buildings in their portfolio, clearly were a major factor in the large volume of new rental supply in London in the second half of the 1980s.

- **Rent Controls** - the large number of new projects which were started in London in the second half of the 1980s were planned in an era of tightening rent controls. By mid 1985, developers (and other investors) in new rental buildings clearly understood that their properties would be subject to controls yet it does not appear to have had a major impact on their decision. In many of the newer rental buildings, the rents that could be charged to tenants in the relatively soft London rental market were well below the rents that the buildings were allowed to charge under the Province's rent control scheme - the market simply would not bear the higher rents.

While it is apparent that many developers and investors proceeded with rental investment despite the fact that their rental properties would be subject to Ontario's rent control system, discussions with other developers who were previously active in the rental market indicate that the controls do present a problem for many developers. An example is a developer who has a large portfolio of existing rental properties with controlled rents held well below the market level. Because the units are always fully occupied but returns are limited by the rents that can be charged, less maintenance and replacement of worn-out equipment occurs and there are more tenant complaints. Many developers are simply unwilling to submit to the public opprobrium that attends such (often very public) complaints and, therefore, do not build new rental housing - and, in some cases, sell their portfolios to others. Many of the syndications of buildings in the London area were existing properties sold by such companies to syndicators.

- **Landlord/Tenant Legislation** - landlords and developers perceive that the balance in landlord/tenant legislation in Ontario has shifted perceptibly in recent years in favour of increased tenants' rights. This, along with rent controls, presents a problem for many potential investors in the market. The perceived lack of public awareness of the difficulties faced by landlords with problem tenants makes the whole process of investing directly in rental property less attractive and, according to many officials familiar with the market, results in less interest in rental investment.

However, given the number of new projects built in London in the late 1980s, this does not appear to have been a major factor in deterring rental investment in this period.

- **Condominium Conversion Legislation** - virtually all new rental buildings in London are registered as condominiums when they are built. This is considered by most developers to be an essential component of an investment strategy to keep their options as open as possible: selling units in the building to individual investors or owners in the future could be more profitable than selling the building as a rental property. It is, of course, also a means of avoiding a further tightening of rent controls - if that should occur, and if the government does not also pass legislation preventing the sale to homeowners of units in a condominium rental building.

Syndications generally involve the sale of individual units to investors (though rental revenues and costs are pooled). Investors in syndicated buildings are more likely to be attracted to the ownership of a dwelling unit than a share of an overall building.

- **Restrictive Land Approvals Practices, Etc.** - there does not appear to be any shortage of land for new multiple unit buildings in London, therefore, shortages do not appear to be a factor in the market.

The relatively plentiful supply of multiple land, in fact, may have been a consideration for some developers to build. Unable to market land they already held (as a non-producing asset), development with rental housing offered at least a long-term promise of a profitable return for developers.

- **Lender Policies** - the difficulties being faced by many of the syndicated rental properties in London (and elsewhere) would appear to indicate that the lenders on some of the properties took a more optimistic view of the market than appears warranted in retrospect. Some syndicated projects are in the hands of the lenders; some others are in difficulty. It would appear that the willingness of lenders to finance new rental projects on the basis of their value as condominiums plus optimistic forecasts of cash flow were a factor behind the large volume of rental construction in London in the second half of the 1980s.

The policy of lenders to finance buildings on the basis of their values as condominium units was a critical factor behind the financial viability of many new rental properties in London. A change in government policy which would lead to the prohibition of the sale of individual units in a rental condominium building could make a significant impact on the financing available for rental properties in future - to say nothing of the viability of existing loans to rental condominium properties which are based on the (much higher) condominium value.

- **Real Estate Market Trends** - increasing construction or land costs do not appear to have been a major factor in hampering rental investment in London. The opposite may, in fact, be true - because there was so little demand for condominiums in the City, developers had little alternative market for their land. This may have been a consideration for many developers to either build for their own portfolio or sell to syndicators.

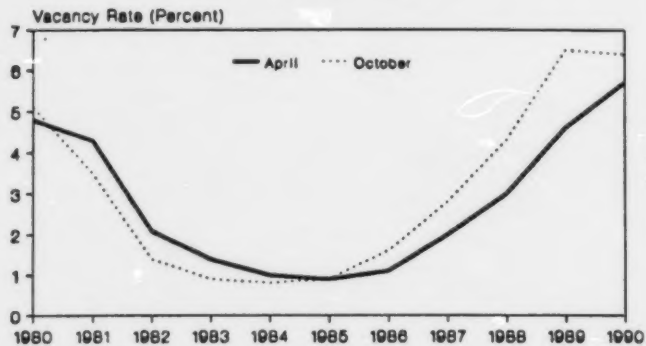
The London rental market is currently adjusting to the oversupply of rental housing resulting from the large number of rental completions in recent years. In combination with the slowing economy, this oversupply seems likely to last for a few years. It seems unlikely that new rental investment will be attractive again in London until the market tightens and rents in new buildings increase to nearer the levels planned when the projects were started. In some cases, however, particularly with some of the more optimistic syndications in London, it seems unlikely that rents will increase to the levels projected in the prospectuses provided to investors.

4.2.7 Why London?

The question arises of why London experienced such a large volume of new rental activity when many other Ontario centres, particularly Toronto, which are subject to the same general legislative environment in terms of rent controls and landlord/tenant legislation, had relatively little private rental construction. There are several factors which appear relevant here:

- First, however, the premise that London alone experienced an increase in new rental building activity is itself false. Many Ontario centres, including Toronto, experienced increased volumes of new rental construction in the late 1980s. Syndications for tax shelter purposes appear to account for the majority of these projects, but developers building for their own account were active in other centres as well. Notwithstanding this, London does seem to have experienced the largest volume of new rental construction relative to its size.
- The image of London as a stable, conservative community, a "safe" place to invest, appears to have been an important factor in the success of many of the syndications in London. Investors perceived that London was less likely to experience the cyclical economic trends which could occur in many other centres in the province.
- A larger number of developers based in London appear to consider the long-term investment advantages of rental accommodation attractive than is the case in many other centres. London developers also appear to have been responsible for much of the building in other nearby centres such as Kitchener and Guelph. In most cases, these developers consider rental investment as a supplement rather than a replacement for other types of real estate investment such as commercial and industrial buildings. While the returns on non-residential real estate appear to be generally higher than for residential rental, they are more volatile as well; if major tenants move out, returns from commercial and industrial rental properties can be reduced significantly. In contrast, residential rental returns may be lower but they are much more stable; even in times of high vacancies, the loss in revenues is much smaller than if the only (or even major) tenant in a commercial property vacates and cannot be replaced.
- The lack of a significant condominium apartment market in London appears also to have been a factor in the decision of many developers to build rental housing instead. With relatively low prices for both townhouses and single-detached houses, and few problems commuting, the cost and locational advantages of living in a condominium apartment in London (even in the downtown area) do not appear to be sufficient to generate a large market for such accommodation. Without the condominium option, developers are forced to consider developing rental housing on multiple land - or selling to another developer or rezoning. Many of the projects for developers' own portfolios appear to have been simply a means of converting a non-producing asset (vacant land with little sale value) into a long-term asset.

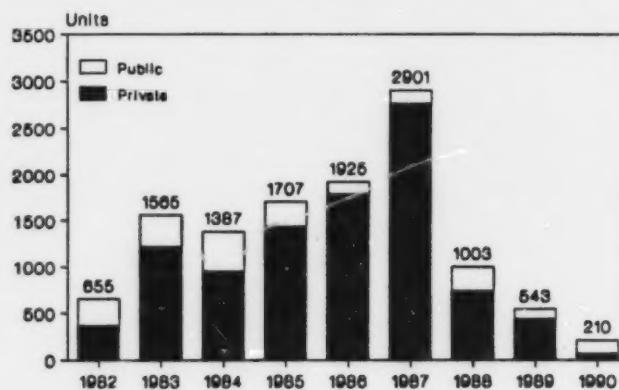
**EXHIBIT 4-13
RENTAL APARTMENT VACANCY RATE-
WINNIPEG, 1980-1990**



* Vacancy rate in rental apartment structures of 6 or more units excluding newly completed.

Source: CMHC

**EXHIBIT 4-14
RENTAL STARTS, WINNIPEG
1982-1990**



Source: CMHC

4.3 ANALYSIS OF TRENDS IN THE WINNIPEG RENTAL MARKET

4.3.1 Large Oversupply of Rental Housing Downward Pressure on Rents

The Winnipeg rental market is currently heavily oversupplied. The rental apartment vacancy rate in April, 1991 was 5.8 percent. This was virtually unchanged from April, 1990, but it is well above the levels which prevailed over the period since the early 1980s. Rental apartment vacancy rates were in the 0.8-1.6 percent range in the 1983-1986 period.

A large increase in rental construction in Winnipeg in the mid 1980s was responsible for the current oversupply of rental housing in the City. Between 1983 and 1987 (when vacancy rates first started to increase significantly), there were an average of 1,900 rental starts annually in Winnipeg. As these projects were completed, they clearly exceeded the annual increase in rental demand in the City with the resulting impact on vacancy rates. Since 1987, the volume of new rental starts has declined and is expected to remain low at least until the current oversupply is absorbed.

The tight market, followed by the subsequent oversupply of rental housing, is mirrored by the trend in rents in Winnipeg. In the 1982-1985 period, rents were increasing at a rate in excess of the CPI, despite the Province's rent control program; however, with the increase in vacancy rates, rents have been declining in real terms in recent years.

4.3.2 The Question: Why Was So Much New Rental Housing Built When Winnipeg Has Rent Controls?

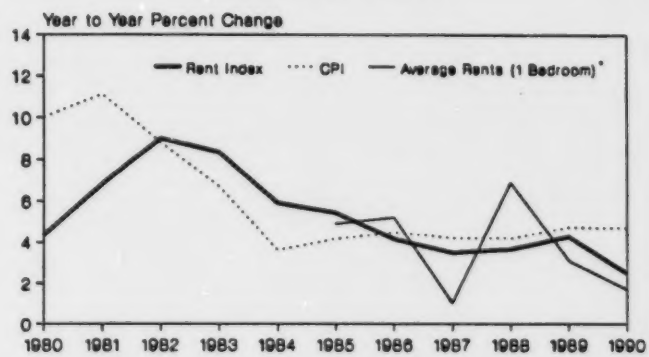
The Winnipeg rental market has been subject to rent controls since the mid 1970s. New rental projects are exempt from controls for an initial period of five years but are then subject to control along with the rest of the stock. The developers of the new rental housing built in the 1980s would clearly have known the rents in their projects would be controlled eventually.

Why did rental housing investors build so much new rental housing in Winnipeg when the projects would be subject to controls?

4.3.3 The Answer: Government Incentives and Tax-Driven Syndications Made Projects Look Financially Attractive

The following pages present an analysis of the economics of new rental investment in Winnipeg and the reasons behind the large number of rental housing projects built in the City in the period since 1985. The analysis shows that new rental projects were not financially attractive in Winnipeg in 1990 due to a variety of factors such

**EXHIBIT 4-15
RENTS AND INFLATION
WINNIPEG, 1980-1990**



* October rents
Source: Statistics Canada and CMHC.

as high interest rates, high vacancy rates and low rents (and low expectations of rent increases).

In the mid 1980s, however, the outlook was different. Rents were increasing above the rate of inflation, interest rates were relatively low, vacancy rates were very low and there were a number of government subsidy programs available to stimulate new private rental investment. The government programs included CRSP loans, leased land in the core areas of the City and low-interest loans under the Winnipeg Core Area Program.

The programs were instrumental in stimulating several large new rental projects in the downtown area of Winnipeg. In some cases the programs were incorporated in tax shelter syndications; in others, they were utilized by developers for projects built on their own account. In addition, there were some other developers who were building projects without government assistance (both syndications and one particular major developer who was building for his own account) as well as non-profit housing. In combination, the result was that a number of new rental projects were built - too many for the slow-growth Winnipeg rental market to absorb.

Virtually all of the new projects are suffering from very high vacancies and lower than expected rents - and substantial losses. Some projects have failed and others are in danger of failing.

As a result of the current depressed state of the rental market, there have been few new rental projects started in Winnipeg in the past two years.

4.3.4 Negative Cash Flow for New Rental Projects

The economics of building a typical new rental project in Winnipeg are summarized in Exhibit 4-16 which is based on information provided by the Winnipeg Office of CMHC in 1990 with some adjustments by Clayton Research. The project is a walk-up apartment in a suburban location with 50 two-bedroom units with 850 square feet of rentable space per unit. Summarizing the results:

- The total project cost is \$59,500 per unit.
- Annual gross income in the initial year is \$7,770 (based on an average monthly rent of \$650 and an assumed 5 percent vacancy rate).
- Operating costs and mortgage payments (assuming a 75 percent mortgage financed at 13 percent over 25 years) exceeds gross income and results in a negative cash flow of \$855 in the first year.
- by the tenth year, there is projected to be a positive cash flow (based on an assumption of 3 percent increases in rents and 4 percent increases in operating costs).

EXHIBIT 4-16

PRO FORMA OF RENTAL INVESTMENT, WINNIPEG (\$ per unit)

Project Cost

Land	5,000
Construction and Soft Costs and Profit	54,500
Total Project Cost	59,500

Project Financing:

Total Project Cost	59,500
Mortgage	44,625
Equity	14,875

Annual Revenues and Costs

	Year 1	Year 10*
Revenues		
Rental Income	7,800	10,175
Vacancy (5%)	(390)	(510)
Other Income	360	470
Gross Income	7,770	10,135
Operating Costs	2,720	3,870
Net Operating Income	5,050	6,265
Mortgage Payments		
Principal	270	835
Interest	5,635	5,070
Total	5,905	5,905
Net Income	(855)	360

* Income and operating costs assumed to increase 3% and 4% per year, respectively.

** Mortgage rate of 13% over a 25 year term.

Source: Clayton Research Associates based on information from CMHC.

The negative cash flow on this project is small relative to the situation in many other centres in Canada. With lower interest rates than the 13 percent rate that prevailed in 1990, the project could have been in a positive cash flow position in the early years; at an 11 percent interest rate, the annual mortgage payments would be \$5,155 so the project would generate a small negative cash flow of \$100 even in the first year - if the market was in relative balance and the project had only a 5 percent vacancy rate.

These estimated costs for a suburban low-rise rental building were confirmed by discussions with industry officials in Winnipeg in 1990. In general, they were less than the costs of many of the new high-rise projects built in the City in the second half of the 1980s; however high-rise construction costs are higher and there is little difference in land costs.

4.3.5 New Projects Suffering Substantial Losses

Exhibit 4-17 presents the financial details of five actual and potential rental projects in Winnipeg. The examples were gathered through discussions with developers in the City in 1990. In some cases, they have been altered slightly to protect the confidentiality of those providing the information. In particular, the pro forma information for projects which had favourable financing arrangements such as CRSP loans and other incentives have had to be changed in order to ensure confidentiality since only limited numbers of projects obtained these financing arrangements.

- Project W-1 - a low-rise rental apartment project under consideration in 1990 by a Winnipeg developer who ultimately decided not to proceed with the project. The pro forma was based on a project the developer built in 1987 with costs updated to 1990 dollars. The total per unit project costs do not include over \$4,000 per unit in the developer's own fees which would have been incurred had the project gone ahead - normally, these should have been included in the pro forma since a developer would want to cover these. The mortgage loan appears to be set deliberately below the maximum in order to attempt to minimize the size of the negative cash flow.

The total project cost was estimated at almost \$55,000 (not including some of the developer's fees and with land at a relatively low cost). The developer believed the projected rents were optimistic in view of market conditions at the time, the vacancy rate in the project was assumed to be 3 percent and operating costs also appear low. Despite these positive assumptions, the project still was projected to generate a negative cash flow in the first year.

As noted, this project did not proceed as the developer did not consider the economics to be attractive. In particular, the soft rental market in Winnipeg made the 3 percent vacancy rate assumption questionable. Also, since the developer was not putting in overhead and profit numbers that would normally apply, there appeared to be little reason to proceed. When the

EXHIBIT 4-17

PRO FORMA OF RENTAL INVESTMENT, WINNIPEG

	W-1	W-2	W-3	W-4	W-5
Project Type	Low-Rise	High-Rise	Low-Rise	High-Rise	Low-Rise
Unit Size (Sq. Ft.)	N/A	N/A	2-Bedroom	N/A	N/A
Interest Rate	13.00%	11.00%	11.75%	11.00%	10.50%
Project Cost			(\$ per unit)		
Land	3,705	N/A	N/A	N/A	3,500
Construction and Soft Costs and Profit	51,220	N/A	N/A	N/A	32,975
Total Project Cost	54,925	66,100	65,000	N/A	36,475
Project Financing					
Total Project Cost	54,925	66,100	65,000	N/A	36,475
Mortgage	40,000	43,700	45,000	45,660	25,930
Equity	14,925	22,400	20,000	N/A	10,545
Annual Revenues and Costs					
Revenues					
Gross Income	7,610	6,680	6,950	7,235	5,600
Operating Costs	3,120	4,725	3,510	4,315	3,325
Net Operating Income	4,490	1,955	3,440	2,920	2,275
Mortgage Payments	5,290	5,050	5,475	5,275	2,750
Net Income	(800)	(3,095)	(2,035)	(2,355)	(475)

Source: Clayton Research Associates

market tightens and interest rates decline, it seems likely that this project could proceed.

- Project W-2 - a high-rise apartment building completed in the late 1980s by a developer building for his own portfolio. Much of the relevant information regarding this project has been suppressed to protect the confidentiality of the developer. The data are from the project's financial statements and relate to the year 1989.

The rents on the project were below initial expectations as a result of the soft rental market in Winnipeg. Operating costs appear very high in this project: on a per unit basis, the major costs were salaries and property management fees (\$950) and maintenance and utilities (\$1,385). The project generated a large negative cash flow in 1989.

The developer could, of course, also utilize CCA to generate an additional loss (for tax purposes) to deduct against income from other sources - CCA per unit for this project in 1989 was \$1,240.

- Project W-3 - a low-rise condominium rental building built in the late 1980s and syndicated as a tax shelter investment. Much of the relevant data regarding this project has been suppressed to maintain confidentiality. The annual revenues and costs relate to the year 1989.

The project costs include syndication fees as well as the other normal capital costs of a project. Also, the operating costs include a significant amount for condominium charges (\$130 per month). The project clearly is not performing well. The negative cash flow exceeded \$2,000 annually and, while a portion of this may be financed by a cash flow loan or some such mechanism (these details were not available for this project), it is clear that it will be some time before the project reaches a positive cash flow situation. According to the developer, the value of the property was \$25,000-\$30,000 in 1990 (based on the net operating income) - well below the outstanding value on the mortgage.

- Project W-4 - a high-rise rental apartment building syndicated for tax shelter investors in the second half of the 1980s. Much of the relevant information for this building has been suppressed for reasons of confidentiality. The data relate to the first half of 1990 (they have been annualized here).

Revenues on the project were over 20 percent below the level projected in the prospectus. Therefore, rather than an expected positive cash flow of \$1,925 per unit in 1990, the project had a significant negative cash flow. The investors were protected to some extent by a cash flow guarantee provided by the developer, however, this has likely run out, given the losses which the project has suffered.



- Project W-5 - a low-rise rental apartment project built in the late 1970s in a suburban location. The project was a MURB and also obtained ARP assistance. The purpose of including this project in this analysis is to show that even older rental projects in Winnipeg are suffering in the current rental environment.

The total project cost to the investors was \$36,475. This was financed with a 10.5 percent \$25,930 first mortgage plus equity contributions from the MURB investors phased over the first several years of the project (in line with their tax savings). The ARP loan assisted in overcoming some of the shortfalls in the cash flow of the project in the early years.

The original financing for this project is still in place. The payments on the first mortgage are the same as when the project commenced. The ARP assistance terminated in the mid 1980s and payments on the ARP loan commenced a year and a half later. These ARP payments are not shown in the pro forma since they are not germane to the discussion of trends in the rental market in Winnipeg at present. What is germane, however, is that the project was generating negative cash flow even without allowing for the ARP repayments. The revenues and costs shown in the pro forma relate to 1989 which was a significant improvement over the performance the previous year when lost income due to vacancies and rent discounts accounted for over 20 percent of gross potential revenue as estimated by the operator. In 1989, rents were stabilized and gross income increased, however, the project was still generating a loss. This has resulted in continuing cash calls on the investors more than a decade after the project was completed.

With a further decline in vacancy rates in the project, the operator expected that the losses would cease; however, with little prospect of significant increases in rents over the next several years, this project is still only marginally viable.

In the case of two of the projects described above, the actual negative cash flow from the projects, while very substantial, was less than is shown in the Exhibit. This is because the financial results for the projects have been adjusted to remove some of the effects of favourable financing through CRSP loans, leased land or other means of subsidizing the projects, so as to protect the confidentiality of the informants. While the adjustment reduces the amount of the negative cash flow being experienced in the projects by 15 and 25 percent in the two projects, the major conclusion remains - the projects were suffering negative cash flows which were much greater than expected.

The problems faced by the recently completed rental projects in Winnipeg could worsen in the next year or two. With prospects of a lock-in of rents at their current low rates as the projects become rent controlled after the first five years, the financial prospects of these projects could be severely threatened.

EXHIBIT 4-18

PRO FORMA OF PURCHASE OF
EXISTING RENTAL BUILDING, WINNIPEG

Project Type	High-Rise
Unit Size (Sq. Ft.)	1,100
Interest Rate	11.00%
	(\$ per unit)
<u>Project Cost</u>	26,500
<u>Project Financing</u>	
Total Project Cost	26,500
Mortgage	19,870
Equity	6,630
<u>Annual Revenues and Costs</u>	
Revenues	
Gross Income	5,665
Operating Costs	2,800
Net Operating Income	2,865
Mortgage Payments	2,295
Net Income	570

Source: Clayton Research Associates based
on information from CMHC.

4.3.6 Existing Rental Projects Trading at Low Prices

Sales of existing rental projects in Winnipeg indicate continuing interest in the rental market by investors. Exhibit 4-18 presents the financial details of the recent sale of an existing high-rise rental project in the central part of the City:

- The building sold for \$26,500 per unit - a capitalization rate of 10.8 percent of the net operating income of \$2,865.
- Vendor-take-back financing at the rate of 11 percent was arranged on 75 percent of the purchase price.
- The building was rent controlled and was full - the pro forma assumed less than a 2 percent vacancy allowance. Rents in the project averaged \$450-\$600 per month for a large suite (average of 1,000-1,100 square feet for a two-bedroom unit).
- The project generated a positive cash flow from the first year. In fact, taking account of the principal payments as well as the cash flow generated in the first year of the project, the investor calculated gross income of roughly 11 percent on the invested capital of \$6,630 per unit in the first year. The longer-term outlook is for increased cash flow as rents rise (they are considered to be below market) so the expected return on investment in this case is much higher.

With this relatively attractive rate of return on an investment in an existing rental property, the economics of building new rental projects do not look attractive in comparison. The investor did, however, face the likelihood that in a few years the project will require substantial renovations which will impact on the economics of the project. But, since many of these costs will be able to be passed on to tenants through the rent control provisions, it appears likely that attractive rates of return will continue on this project.

4.3.7 Government Programs, Tax Shelters - Instrumental in Large Volume of Rental Building in Winnipeg

The surge in rental construction in Winnipeg in the mid 1980s can be traced largely to a proliferation of government rental incentive programs and tax shelter arrangements which spurred new rental construction in the City. Due to the high level of building, the market is currently heavily oversupplied and little private investment in new rental housing is expected in the next few years.

To conclude this analysis of the Winnipeg rental market, a review of the importance of each of the major factors which are considered to influence the attractiveness of rental investment (identified in Chapter 2 of this study) is presented - with commentary on their applicability to the Winnipeg situation:

- **Government Incentive Programs** - these were clearly a major factor behind the large volume of new rental construction in Winnipeg in the mid 1980s. A variety of programs were involved: CRSP loans, write-downs of interest under the Winnipeg Core Area Program and land lease arrangements. These programs provided significant subsidies to many of the projects built in Winnipeg during this period; they were probably instrumental in many of the projects proceeding to construction when, without the subsidies, they may not have proceeded.

In the view of many observers of the rental market in Winnipeg, these programs created an artificial supply which, in the long-term, had no sound economic basis. Most of the projects are losing money at present due to the oversupply.

- **Government Supply** - several new non-profit housing projects have been built in Winnipeg in recent years and, in some cases, they appear to be directly competitive with private rental development. In particular, two life lease projects in the downtown area are designed to appeal to the empty-nester and seniors market that is the target market for some of the private projects. The rents in these projects are not markedly lower than those charged in the new private rental buildings.

It appears that publicly supplied new housing is having a negative impact on the private rental market in Winnipeg. However, it seems clear that this supply was not a significant consideration in the surge in new private rental investment in the City in the mid 1980s.

- **Interest Rates** - the relatively low interest rates which prevailed in the mid 1980s were likely a factor in many of the projects that were built. In some cases, the prevailing market interest rates were not important because they received low-interest loans from government sources. Many of the projects would likely not have been attractive to investors at the higher interest rates that prevailed in 1990. The rise in interest rates in 1990 is not considered to have been a significant factor behind the reduction in new rental building since the soft market made new construction less attractive.
- **Tax Policies** - much of the rental investment in Winnipeg in the 1980s was through tax-driven syndications of rental properties. These projects were specifically designed to appeal to high-income investors who wish to shelter income from taxes.

While not likely as important a factor in the Winnipeg situation as was the case in London, tax shelters represented a significant component of the surge in rental investment in Winnipeg in the mid 1980s. A large proportion of the projects built in this period were syndications - many of the projects also had CRSP or other subsidy assistance.

The ability of landlords to use CCA (and other losses) on newer buildings to offset taxes payable on the positive cash flow generated by other rental properties was also a factor in the new rental supply in Winnipeg in the mid 1980s. One major developer in particular appears to have proceeded with a large new development when market prospects appeared poor; no doubt, the ability to deduct losses on this new development from income from other properties was a factor in this decision.

- **Rent Controls** - these do not appear to have been a significant negative factor in the decision-making of the large number of rental investors who built new projects in Winnipeg. The Manitoba regulations exempt new rental projects for a period of five years and this would mitigate the negative aspects of rent controls on new investment to some extent since this would allow a lengthy period for the project to establish itself in the marketplace at free market rents. This advantage may be lost for many of the new projects since they are approaching the five-year deadline and, with the soft rental market, rents will be locked-in at a relatively low level.

As with the London situation, the fact that a large volume of new rental construction occurred in Winnipeg's rent controlled environment does not necessarily mean that controls have not had an impact on investment. Several of the developers interviewed in the course of investigations for this study indicated that they were not prepared to invest in rental property under the current rent control and landlord/tenant legislation. However, it is apparent that this view does not hold for all investors.

- **Landlord/Tenant Legislation** - as with rent controls, these do not appear to have been a significant negative factor in the investment decisions of those building new rental projects in Winnipeg in the mid 1980s. Landlords in Winnipeg do, however, perceive a shift in the balance of legislation towards the tenants and, for many potential investors, this has resulted in a withdrawal from the rental market.

One official, who was no longer involved in building new rental housing but had a large portfolio, observed that residential rental properties accounted for 30 percent of his portfolio but 80 percent of his overhead - because of tenant complaints.

- **Condominium Conversion Legislation** - most new rental projects in Winnipeg are registered as condominiums and the City has relatively permissive condominium conversion regulations for rental properties which are not condominiums. This is not considered to be a significant factor in the rental investment climate in Winnipeg.
- **Restrictive Land Approvals Practices, Etc.** - there is no shortage of land for rental or other types of housing in Winnipeg. This is not considered to be a factor in the surge in rental starts in the City in the mid 1980s.

Several observers did, however, note that the City has recently imposed new regulations with regard to taxation of rental properties which have significantly increased the property taxes payable on rental housing which is registered as a condominium. To the extent that this is true, most new rental buildings built in the past several years will be negatively impacted and future investment in rental housing will be curtailed.

- **Lender Policies** - as in London, it appears that some lenders took too optimistic a view of the rental prospects of some new projects in Winnipeg with the result that some projects have come back to the lenders. The practice of lending on the value of the project as a condominium was a factor in the financing of the new private rental projects in Winnipeg.
- **Real Estate Market Trends** - construction and land costs have not increased significantly in Winnipeg in recent years so these were not a factor in the new rental investment.

The condominium market in the City is heavily oversupplied, as well as the rental market, so this could account for some of the rental production since developers did not have the alternative of building new condominium projects as appears to have been a factor in Vancouver.

It will likely be several years before the current oversupply of rental housing in Winnipeg is absorbed by the market. In the meantime, it is unlikely that significant amounts of new private rental housing will be built - or will be needed. When the market regains a balance, there will be likely be a period of relatively little new supply until the market tightens to the extent that the achievable rents on new rental projects increase to levels attractive to rental developers - unless the government intervenes either with significant new supply or new rental incentive programs.

4.4 CONCLUSION

The reason why Calgary, London and Winnipeg were selected for analysis in this study was that they appeared not to conform to the theoretical operation of the rental housing market. In terms of the criteria established for assessing efficiency in the rental market (Section 2.4), it appears that actors in all three markets are reacting in a rational manner to market signals:

- In Calgary, the reason why no new rental projects were built in the late 1980s and 1990, despite rising rents and the absence of rent controls, was that rents had not risen enough to make new buildings an attractive investment.
- In London, the reason why several new rental projects were built in the late 1980s in spite of an increasingly restrictive rent control environment was

that investors expected to earn a competitive rate of return on their investment. Subsequent events have proven them wrong in many cases and little new rental investment is now taking place.

- In Winnipeg, the reason why so much new rental housing was built in the 1980s despite the fact that Winnipeg has rent controls was due to a combination of factors. These included government incentive programs and tax-driven syndications which made projects appear financially attractive plus the fact that new rental projects are exempted from controls for five years. As in London, new investment in rental housing has fallen off in Winnipeg in response to high vacancies.

Upon examination, therefore, rental market trends in none of these three centres indicate any apparent contradiction to the theoretical operation of rental markets as described in Chapter 2. In general, agents appear to have reacted rationally to market signals in all three centres.

In terms of government intervention creating inefficiency in the rental market, it appears that the rental incentive programs provided in Winnipeg were a significant factor in the oversupply in that market. Also, it is apparent that tax shelter investments (with unrealistic assumptions) as allowed under federal tax laws were a significant factor in the oversupply in both Winnipeg and London. Finally, the less restrictive rent control regulations in Winnipeg (compared to those applying in some other parts of Canada) appear to be less of a negative factor on new rental investment than the more restrictive rent control regimes.



CHAPTER 5

THE MONTREAL RENTAL MARKET

The Montreal Census Metropolitan Area (CMA) encompasses Canada's largest rental market. It has also been the most active market in terms of new rental construction in recent years, despite the fact that it is subject to a form of rent control.

This chapter examines the operation of the rental market in Montreal. The emphasis is on the supply side of the rental market. The chapter includes an overview of recent trends in the Montreal rental market, an examination of the structure of the rental supply industry and an analysis of the demand and supply factors which are relevant to the apparent contrast between the operation of the Montreal rental market and the operation of markets in other parts of Canada. The analysis is intended to identify the reasons why construction of new rental housing escalated in the 1985-1987 period despite a rent controlled environment and why construction has continued at relatively high levels despite increasingly adverse market conditions.

The analysis is based on a variety of sources including interviews with developers and other individuals knowledgeable about the industry, a review of relevant literature and the results of a survey of recent investors in rental housing in Montreal which was undertaken in conjunction with this study.⁴³

5.1 OVERVIEW OF RECENT TRENDS IN THE MONTREAL RENTAL MARKET

This section provides an overview of recent activity in the rental housing market in Montreal.

5.1.1 Rental Production Increased Dramatically in 1985-1987, But the Product Was Different Than in the 1970s

Rental production was high in Montreal through most of the 1970s, but fell off dramatically in the early 1980s. The decline in activity in the early 1980s reflected a variety of factors which also impacted other rental markets across Canada. They included:

- **The end of the ARP program** - this program provided subsidies (which were up to \$100 per unit per month in the Montreal area) to developers of private market rental units;

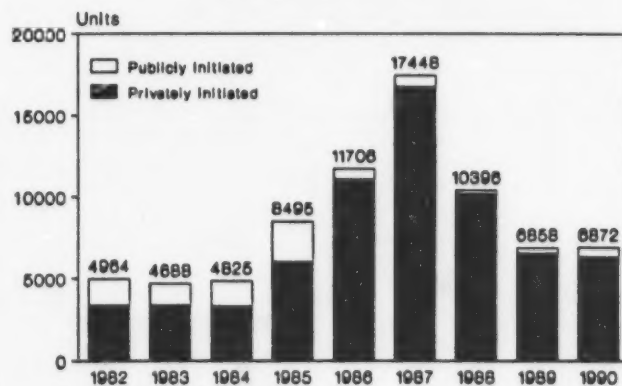
43 Details on the survey of rental investors are presented in a separate volume, in Appendix A.

EXHIBIT 5-1
PRIVATELY INITIATED RENTAL APARTMENT
COMPLETIONS BY SIZE OF STRUCTURE
MONTREAL, 1970-1990

	<u>Under 6</u>	<u>6-19</u>	<u>20-49</u>	<u>50-199</u>	<u>200+</u>	<u>Total</u>
<i>Average Annual Number of Units</i>						
1970-1979	1,592	3,792	1,966	2,830	1,495	11,675
1980-1984	628	1,615	374	243	43	2,902
1985-1990	2,445	4,033	804	1,051	326	8,659
<i>Percent Distribution</i>						
1970-1979	14	32	17	24	13	100
1980-1984	22	56	13	8	1	100
1985-1990	28	47	9	12	4	100

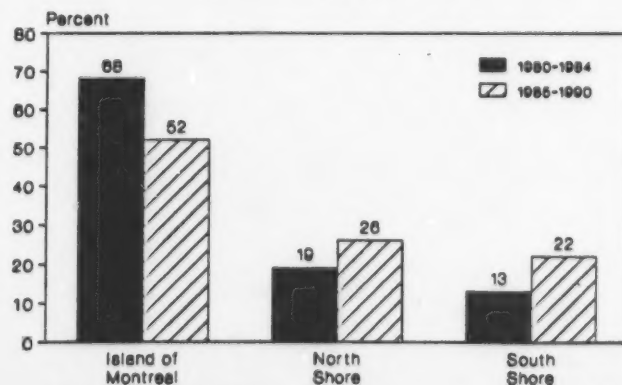
Source: CMHC.

EXHIBIT 5-2
RENTAL STARTS BY INTENDED MARKET
MONTREAL, 1982-1990



Source: CMHC

EXHIBIT 5-3
LOCATION OF RENTAL CONSTRUCTION*
MONTREAL, 1980-1990



* Approximated by apartment starts.
Source: CMHC

- **Less favourable tax treatment of rental housing** - the ending of the MURB provision, as well as other tax changes, made investment in rental housing less attractive;
- **High interest rates** - interest rates increased significantly in the 1979-1982 period, further reducing the attractiveness of rental investment; and
- **A weaker economy** - renter household growth was dampened by poor employment prospects, which negatively impacted demand.

In response to these factors plus relatively high vacancy rates, completions of private rental apartments averaged less than 3,000 units per year in the early 1980s, compared to over 11,000 per year in the 1970s.⁴⁴ The construction of large buildings in particular become less common - in the 1970s as a whole, 37 percent of private rental apartment completions were in structures of 50 or more units; in the early 1980s, these larger buildings comprised less than 10 percent of private rental completions.

Rental production in Montreal increased rapidly over the 1985-1987 period (peaking at almost 17,500 starts in 1987). Starts declined in 1988 and again in 1989, but remained above the levels of the early 1980s. Data for starts in 1990 indicate that rental production has remained steady at the 1989 level. The vast majority of the new rental production is privately-initiated.

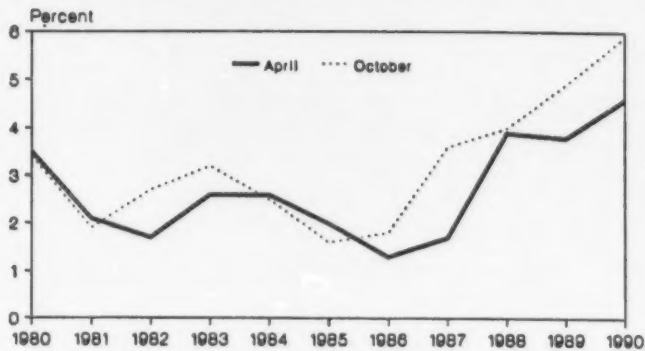
Although the level of rental production has increased relative to the early 1980s, the type of product being built in Montreal in recent years differs substantially from the product of the 1970s. In particular, recent rental production has been dominated by units in smaller buildings - about three-quarters of private rental production in the 1985-1989 period was in buildings of less than 20 units. There was also a small increase in the numbers of units constructed in larger buildings in the second half of the 1980s, but these were virtually all in specialized seniors' projects - of the 7,593 private rental completions in buildings of 50 or more units in the 1985-1989 period, it is estimated that about 7,100 were units in these seniors' projects.⁴⁵

The location of rental construction within the Montreal area also shifted in the second half of the 1980s. Increasingly, more units were constructed away from the Island of Montreal to the North and South Shores. As well, on the Island of Montreal, there has been a shift towards the outer extremities.

44 Two different series are used to illustrate the level and composition of rental construction in the 1980s. The first series (Exhibit 5-1) is CMHC data on "private" rental apartment completions by size of structure (some co-op units are included). The second (Exhibit 5-2) is total rental starts (which includes both row and apartment and publicly and privately initiated units). This latter series is only available since 1982 and does not contain a breakdown by size of building.

45 Based on CMHC estimates on construction of these seniors' projects. More information on the characteristics of these projects is presented in Section 5.3.3.

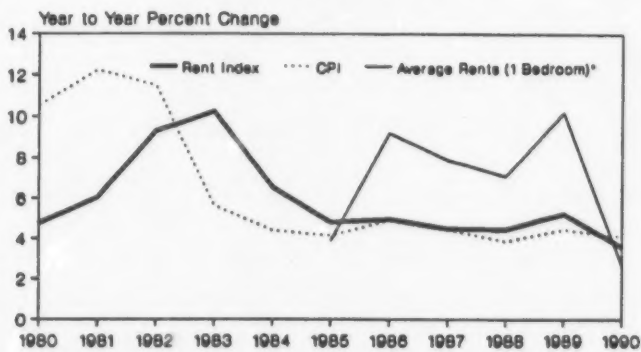
**EXHIBIT 5-4
RENTAL APARTMENT VACANCY RATE*
MONTREAL, 1980-1990**



* Vacancy rate in rental apartment structures of 6 or more units excluding newly completed.

Source: CMHC

**EXHIBIT 5-5
RENTS AND INFLATION
MONTREAL, 1980-1990**



* October rents

Source: Statistics Canada and CMHC.

Non-conventional rental supply does not seem to be as important a factor in Montreal as in many other centres in Canada. Although there is some renting out of single-detached homes and condominiums, the practice does not appear to be widespread, as evidenced by the small number of advertisements in local newspapers.⁴⁶ As well, basement apartments appear to consist mainly of basement apartments in duplexes, triplexes and fourplexes. The survey of rental investors indicated that over 80 percent of new plexes included basement units as did almost 70 of high-rise apartments. These would be included in the CMHC starts data. Basement apartments in homes or other secondary suites seem to be common only for student housing near the universities.

5.1.2 Vacancy Rates Fell to Below 2 Percent in 1985-1986, But Have Been on the Rise Since

The rental vacancy rate in Montreal declined in the 1980 to early 1982 period in response to continuing low levels of production. Although rental production remained low, increases in vacancy rates occurred in the late 1982 to late 1983 period - a reflection of the weak economy of the time, which led to doubling up of households. As the economy improved, vacancy rates again declined in response to the low volume of new rental construction.

The recovery in rental construction in 1985 was not sufficient to keep up with demand and vacancy rates continued low in the 1985 to early 1987 period. The large increases in construction in the post-1984 period eventually were reflected in rising vacancy rates. Despite lower levels of construction in 1988 and 1989, vacancy rates continued to rise through October, 1990 (to 5.9 percent). The vacancy rate in April, 1991 was 5.6 percent.

5.1.3 Rents Have Been Rising Above Inflation Since Mid 1980s

The rent component of the CPI suggests that annual rent increases in Montreal lagged the CPI in the early 1980s, but more than kept pace with the rate of inflation in the 1984-1990 period. Rent increases shown by CMHC data on overall average rents by bedroom count show somewhat higher increases. The rent index suggests that rent increases averaged only 4.6 percent per year over the 1984-1990 period, while CMHC data indicates that rents (for a 1-bedroom apartment) increased at an average rate of 6.5 percent per year.⁴⁷

The discrepancy reflects in part the different orientation of each series. The rent index measures changes in constant quality accommodation. The CMHC series

46 An examination of the Montreal Gazette for a typical day in July, 1990 showed only 124 houses and condominiums for rent; a similar exercise for Vancouver (only about one-third the size of the Montreal rental market) produced almost three times the number.

47 The increases for bachelor and 2 bedroom apartments were also in the 7 percent range, while 3 bedroom apartments were slightly higher at about 9 percent.

reflects the average rent overall for units of a certain bedroom count; as such, it reflects changes to the stock in terms of quality. For example, to the extent that a large number of new units of a substantially higher quality and with higher rents come on the market, this results in relatively higher year-to-year percent increases in rents in the CMHC series, but not the rent index. However, this only partially explains the discrepancy - the rent index is widely believed to understate even pure rent increases to some degree.

Although the actual level of the increase in rents is not clear, it seems nevertheless clear that rents in Montreal were rising at or above the rate of inflation throughout the latter part of the 1980s though, in 1990, they declined in real terms - theory would suggest that this is the expected response to the increasing vacancy rates.

5.1.4 The Question: Why Did Investment in Rental Housing Escalate in Montreal in 1985-1987?

With rent controls in operation in the Montreal market, the question to be addressed in this analysis is what caused the sudden increase in rental investment in Montreal in the mid 1980s? And why has rental construction continued in the face of an increasingly soft rental market since then?

5.1.5 The Answer: A Variety of Factors Combined to Stimulate the Rental Investment Environment

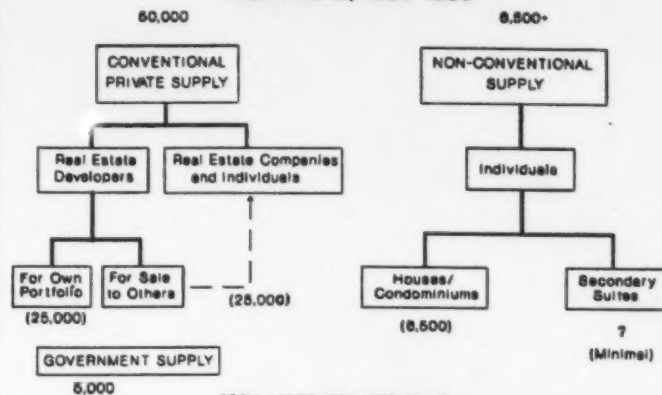
The answer to the question of why rental investment suddenly escalated in Montreal is a complex one - there was not one single factor, but rather a series of factors which combined to produce an environment within which rental investment thrived. These are discussed in detail in the remainder of the chapter.

5.2 THE SOURCES OF RECENT RENTAL INVESTMENT IN MONTREAL

There is little comprehensive information available on the structure of the rental housing industry in Montreal and the primary sources of investment. Yet this information is important for an analysis of the reasons behind the increase in rental construction in the City. The analysis in this section relies heavily on the results of the survey of recent investors in both conventional and non-conventional rental housing conducted in Montreal specifically for this study.⁴⁸

48 The results reflect the combined responses of 419 owners of rental projects constructed since 1984 plus 51 investors in non-conventional rental housing.

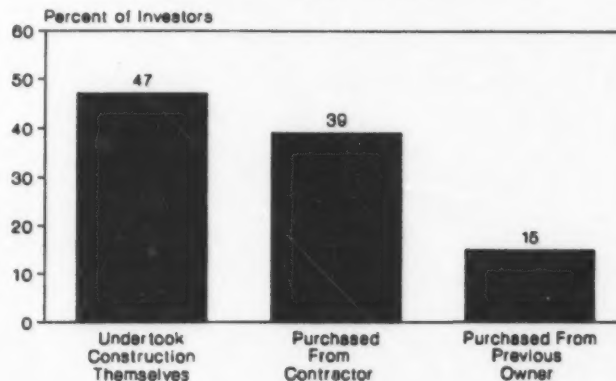
EXHIBIT 5-6 INVESTORS IN RENTAL HOUSING MONTREAL, 1985-1989



TOTAL UNITS 1985-1989-81,500+

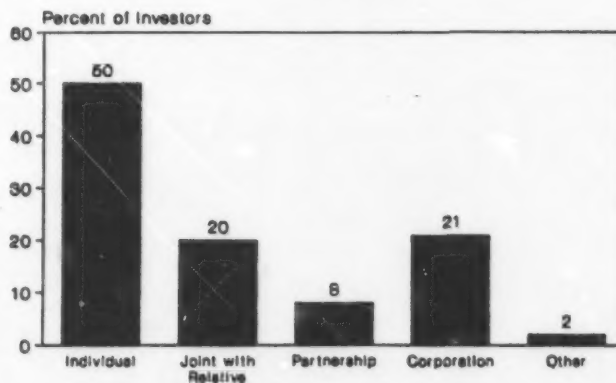
Source: Estimates by J. Hurtubise, Economist and Clayton Research Associates based on CMHC starts data and "Survey of Rental Investors, Montreal".

EXHIBIT 5-7 HOW OWNERSHIP OF RENTAL PROPERTY ACQUIRED, MONTREAL



Source: "Survey of Rental Investors, Montreal".

EXHIBIT 5-8 TYPE OF OWNERSHIP MONTREAL



Source: "Survey of Rental Investors, Montreal".

5.2.1 Developers Building For Their Own Portfolio or For Sale Account For Most New Rental Housing

Estimates of the number and proportions of rental units produced by each major type of investor in the Montreal market in the 1985-1989 period are presented on the opposite page. Highlights include the following:

- The dominant group were suppliers of conventional private rental housing - approximately 80 percent of units fall into this category.
- Government supply is estimated at only 5,000 units for the whole period.
- The net increase in rentals of houses and condominiums is estimated at roughly 6,500 units.⁴⁹ There is no comprehensive information on secondary suites, but this sector is not considered to be substantial in Montreal.

Among conventional suppliers, information from the survey of rental investors indicates that almost half of owners undertook the construction of their buildings themselves. The remaining (slightly more than) half of current owners bought from developers (39 percent) or intermediate owners (15 percent).

5.2.2 Small Landlords Most Prevalent Investors in Rental Housing in Montreal

The survey of rental investors provides a snapshot of the characteristics of investors in rental housing in Montreal since 1984:⁵⁰

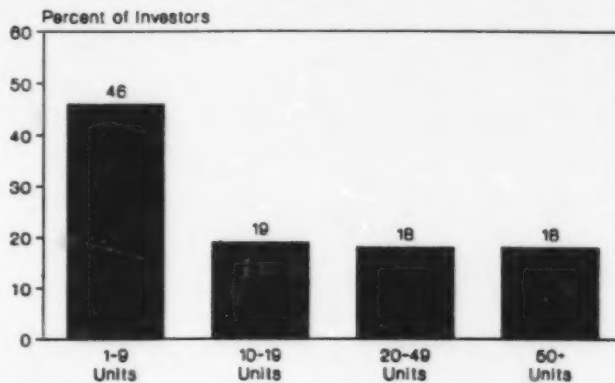
- **Individual ownership most common** - 50 percent of buildings completed since 1984 were owned by individuals; another 20 percent were owned jointly with relatives. Corporations comprised only about 20 percent of ownership.

Not surprisingly, corporate ownership was more common for larger buildings (50 or more units).
- **The small investor dominates** - almost half of investors in rental housing in Montreal in the latter 1980s owned less than 10 units in total; less than 20 percent owned more than 50 units. The median rental portfolio was

49 About 6 percent of single-detached units were rented at the time of the 1986 Census; it is assumed that this proportion increased slightly in the latter 1980s, due to the general air of speculation and overbuilding in the ownership market. It is also assumed that 10-15 percent of new condominiums were on the rental market.

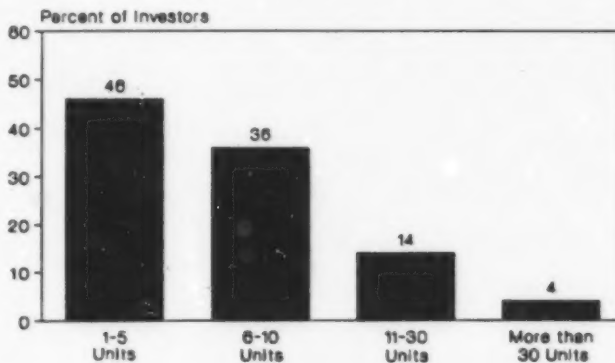
50 These profiles are based on discussions with owners of buildings. To the extent that syndications were operating (and this was mostly with regard to seniors' projects) and it was difficult to contact actual owners, these would be under-represented in the sample; this may bias the survey results somewhat towards smaller owners and rental projects.

**EXHIBIT 5-9
SIZE OF RENTAL PORTFOLIO
MONTREAL**



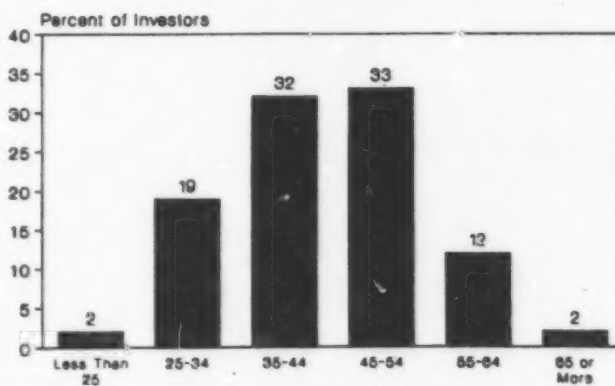
Source: "Survey of Rental Investors, Montreal".

**EXHIBIT 5-10
SIZE OF PROJECT
MONTREAL**



Source: "Survey of Rental Investors, Montreal".

**EXHIBIT 5-11
AGE OF INVESTOR
MONTREAL**



Source: "Survey of Rental Investors, Montreal".

about 15 units, however, 40 percent of investors owned only the building about which they were interviewed.

Almost 60 percent of the investors in single-detached homes and condominiums owned more than 1 rental unit. This may indicate that investors in this type of rental property are also owners of conventional rental housing - for condominiums in particular, it is likely that some owners were developers renting out unsold units.

- **Most invested in smaller projects** - over 80 percent of investors in rental housing surveyed indicated that the project about which they were interviewed contained 10 units or less. Less than 5 percent of buildings in the sample universe had more than 30 units.
- **A large proportion of owners live in the project** - about one-fifth of owners indicated that they lived in the building about which they were interviewed - it is likely that some of the others also live in a project they own, but not the particular one about which they were interviewed. Owners with smaller rental portfolios and those owning plexes were more likely to live in the building.
- **Most owners not full-time landlords** - over 80 percent of owners indicated that they had employment other than as full-time landlords. The proportion decreased with increased portfolio size. Full-time landlords were also more prevalent among those renting out condominiums - again these likely represent developers renting out unsold units in condominium projects.
- **Half the owners developed the property themselves** - almost 50 percent of owners indicated that they developed the project themselves; about 40 percent bought the building from a developer, while the remainder of current owners bought the building from a previous owner (see Exhibit 5-7).
- **Two-thirds of investors are aged 35-54 years** - two out of three investors in rental housing in Montreal since the mid 1980s were in the 35-54 age groups - equally divided between the 35-44 and 45-54 age groups. Investors in condominiums and plexes, and those with smaller rental portfolios exhibited a higher proportion of younger investors. Only 2 percent of investors were aged 65 years or older.

Some of these results can be compared with those of a study conducted by the Ministère de l'Habitation et de la Protection du Consommateur in 1984 which provided a portrait of owners in rental structures in the Province of Quebec as a whole at that time. Although data specifically for Montreal are not available, the fact that Montreal comprises roughly 60 percent of rental housing in Quebec means that the results do have application for the structure of Montreal rental investment at that time. The study showed that small landlords dominated as a percent of all

EXHIBIT 5-12
QUEBEC RENTAL INVESTORS, 1984

	<u>Average Number of Units</u>	<u>Average Number of Structures</u>	<u>Percent of All Units</u>	<u>Percent of All Owners</u>
Small Owner	3	1	32	85
Individual Investor	10	2	15	11
Large Investors	50	5	21	4
Corporation	1,000	30	32	0
Total	8.4	1.3	100	100

Source: Raymond, Chabot, Martin, Pare; "Etude sur la Rentabilité d'un Echantillon d'Immeubles à Logements Locatifs", for Ministère de l'Habitation et de la Protection du Consommateur, April, 1984.

owners (85 percent of owners owned only one building), but accounted for only one-third of all units - the average small owner had only 3 units. Individual investors (average of 2 buildings with 10 units) accounted for a further 15 percent of all rental units. Together, small owners and investors accounted for roughly half the rental stock in Quebec.

Large investors (corporations and large individual investors with rental portfolios averaging 50 units or more) comprised less than 4 percent of landlords, but accounted for slightly more than half of all rental units. The average building size for these groups was 10-35 units.

The conclusion is that although there may have been a shift towards the construction of smaller buildings since the 1984 study, most investors in Montreal have invested in several small buildings rather than fewer large ones. Whereas the 1984 study showed about 85 percent of owners had only one building, the survey of rental investors undertaken for this study indicated less than half of investors in newer units owned only one building.

The interviews with developers and management companies provided additional information on who has been investing in rental housing in recent years though this information cannot be quantified in the same way as the survey results:

- Large developers have not been a substantial player in the conventional rental market for some time; more and more it has become a business for small developer/contractors. These smaller operators either keep the buildings for their own portfolio, or sell them to other small investors. Larger developers have been mainly limited to involvement in syndications (mainly of seniors' projects). Some have also constructed smaller buildings either for sale or for their own portfolio.
- The investors buying small buildings are diverse in character - they comprise a wide-range of socio-economic groups, not merely professionals; often they are two or three members of a family; many entered the rental investment market for the first time during the wave of speculation in 1986-1987. The exemption of the first \$100,000 in capital gains was likely a factor here.
- Investors of European, Asian and Middle Eastern backgrounds were active in both the seniors and other markets, however investment by actual off-shore (foreign) interests in new production was very limited. Foreign investment in the Montreal rental market has been mainly in existing, larger buildings in the central core of Montreal.

**EXHIBIT 5-13
MAJOR REASONS FOR INVESTING
IN RENTAL PROPERTY, MONTREAL**

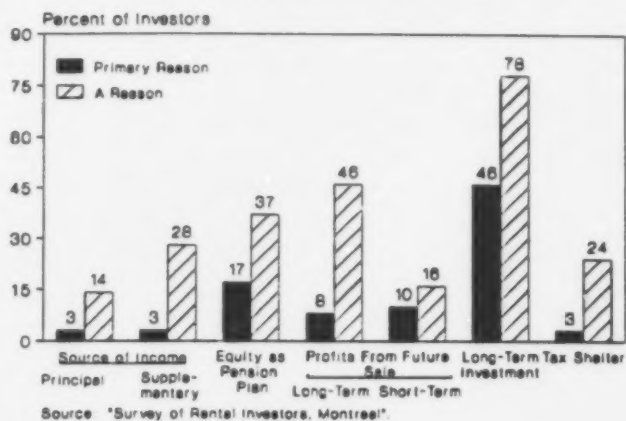
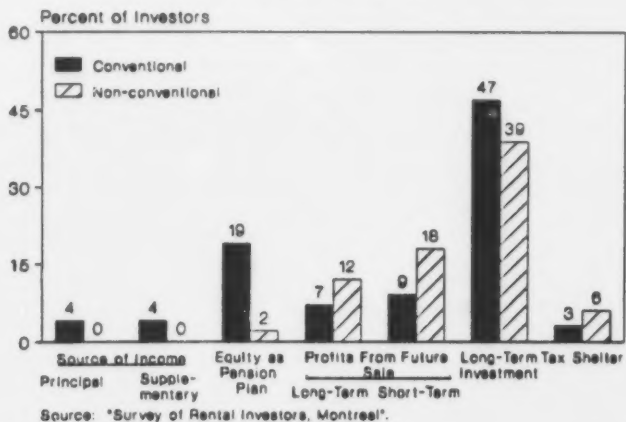


**EXHIBIT 5-14
PRIMARY REASONS FOR INVESTING IN RENTAL
PROPERTY BY TYPE OF RENTAL, MONTREAL**



5.2.3 Long-Term Investment - The Prime Motivating Factor For Rental Investors Since the Mid 1980s

The survey asked recent investors in rental housing to provide the reasons behind their decision to invest in rental housing. Highlights of the responses include the following:

- **Short-term factors were of less importance** - although over 40 percent of investors said that income from the property was a motivating factor behind their decision to invest, only 6 percent indicated that this was the primary reason for their decision. Tax shelter benefits were a factor for about one-quarter of investors, but again, only 3 percent indicated that it was the primary factor behind their decision.
- **Long-term goals were most important** - long-term returns, either as "building equity as a pension plan", "long-term investment", or "long-term profits from future sale" were the primary reason behind the decision to invest for 70 percent of investors.

The definition of "long-term" was left open to interpretation in the survey, however, interviews with larger developers suggest that for larger buildings it may take a minimum of 5 years for a project to begin to show a profit.

Investors in condominiums and houses were more likely to be seeking profits from the sale of the building in the short- or longer-term. There was very little difference in motivations for small (rental portfolio of less than 10 units) versus larger owners.

The interviews with larger developers confirmed these long-term goals. Many interviewers mentioned that investors of European and Asian background had a decidedly longer-term (10 years or more) view of the rental investment than other investors.

5.2.4 Pro Forma Analysis Indicates That Short-Run Returns Did Not Have a Major Role in the Increased Rental Investment of the Mid 1980s

Because of the nature of rental investment in Montreal since the mid 1980s (i.e. generally small buildings owned by an individual or partners), cost and revenue information for projects was more difficult to obtain than in centres where large buildings are being constructed for syndication and prospectuses can provide a wealth of financial information. Nonetheless, information on the financial performance of rental investment has been compiled based on information from the Montreal Office of CMHC, discussions with developers and the survey of rental investors.

Exhibit 5-15 shows the comparative initial position of four projects developed in Montreal since 1985:

EXHIBIT 5-15

EXAMPLES OF RENTAL INVESTMENT PRO FORMAS, MONTREAL

	M-1	M-2	M-3	M-4
Project Type	Low-Rise	High-Rise Seniors	High-Rise Conventional	10 Unit Condominium
Unit Size (Sq. Ft.)	800	530	925	N/A
Mortgage Rate	11.5	11.5*	11.5	11**
Project Cost				
		(\$ per unit)		
Land	7,500	3,500	6,000	N/A
Construction and Soft Costs and Profit	38,200	66,000	65,100	N/A
Total Project Cost	45,700	69,500	71,100	56,000
Project Financing:				
Total Project Cost	45,700	69,500	71,100	56,000
Mortgage	34,300	51,700	53,300	42,000
Equity	11,400	17,800	17,800	14,000
First Year Revenues and Costs				
Revenues				
Gross Income	4,950	14,600	8,000	6,700
Operating Costs	1,350	7,400	2,400	1,500
Net Operating Income	3,600	7,200	5,600	5,200
Mortgage Payment	4,104	6,018	6,377	4,700
Net Income	(504)	1,182	(777)	500

* Mortgage amortization period of 30 years.

** Mortgage rate for first mortgage of 37.500; second mortgage of 4.500 at 8 percent.

Source: Clayton Research Associates, Jules Hurtubise, Economiste and CMHC.

- Project M-1 - a small wood and brick walk-up building of 8 units constructed in 1986-1987. It would be typical of much of the rental housing constructed since 1985.

The initial rents average \$440 per month per unit. At these moderate rents, the project would not be expected to have serious vacancy problems. The project, in its initial year, exhibits negative cash flow of \$500 per unit (or \$4,000 for the building as a whole). The project's cash flow, however, would be expected to turn positive by the fourth year.

This project incorporated an 11.5 percent mortgage rate. At 13 percent mortgage rates, the project's initial negative cash flow would almost be doubled, making it questionable whether it would have proceeded.

For builders intending to keep the building for their own portfolio, the project may be more attractive. Land already held by the builder as a non-producing asset could be used as equity - as could normal builder overhead and profit. Also, to the extent that the owner already has a portfolio of rental buildings generating positive cash flow, losses from the new project could be financed from these other returns.

- Project M-2 - a syndicated high-rise seniors' project of over 200 units constructed in early 1990. The high development costs for the small (530 square feet) units in this project are due to the specialized nature of the project, the need for large common areas, etc.

Operating costs per unit were relatively high for the project, due to the extra services provided for seniors. However, the realization of an initial average rent per unit of \$1,062 was high enough to more than offset total expenses. The project returned a projected net income of just under \$1,200 per unit in its first year.

The return, of course, was conditional on a vacancy allowance of 5 percent at these rents. Initially, demand for this type of product was adequate to absorb available units at these rents. However, the eventual oversupply that occurred in this specialized market resulted in substantially higher vacancy rates than projected for most projects. It is unlikely this project is realizing the positive cash flow indicated in the pro forma.

- Project M-3 - a 96 unit high-rise (not a seniors' project) rental apartment project that is scheduled to be constructed in 1991.

It is not surprising that more of these projects did not proceed - the project is projected to lose about \$800 per unit in the initial year even at an 11.5 percent interest rate. The achievable rents (an average of \$690 per month) are not sufficient to cover operating and financing costs. It is possible that this project may not go ahead given current interest rates and softer rents.

EXHIBIT 5-16

AVERAGE PROJECT PERFORMANCE SURVEY OF RENTAL INVESTORS, MONTREAL

Project Type and Number of Units	Apartment 2-4 Units	Apartment 5-10 Units	Apartment 11-50 Units	House	Condominium
Sample Size* (Number of Respondents)	51	52	19	5	15
	(\$ per unit)				
<u>Project Cost and Finances</u>					
Total Project Cost	62,100	45,400	42,000	116,500	105,000
Mortgage	44,600	32,500	31,600	97,500	33,000
Equity	17,500	12,900	10,400	19,000	72,000
<u>Current Annual Revenues and Costs</u>					
Revenues					
Gross Income	6,100	5,700	5,600	13,100	8,700
Operating Costs**	1,700	1,250	1,150	3,350	3,300
Net Operating Income	4,400	4,450	4,450	9,750	5,400
Mortgage Payments	5,900	4,250	4,550	13,500	8,300
Net Income	(1,500)	200	(100)	(3,750)	(2,900)

* Includes only those investors who provided complete financial information (about one-third of all respondents).

** Includes property tax, insurance and maintenance costs; for condominium, also includes condominium fees.

Source: Clayton Research Associates based on "Survey of Rental Investors, Montreal".

- Project M-4 - a low-rise project of several buildings of 10 condominium registered units each being sold to investors on a 10 unit building basis. The project was marketed in early 1990.

At an 11 percent interest rate for 90 percent of the required financing and an 8 percent mortgage rate (interest only) for the remainder, the project would generate net income of \$500 per unit in the first year. The project could look attractive to a potential investor. Not only was cash flow expected to be positive in year one, but substantial tax savings were possible based on soft costs of \$4,500 per unit. Since the building was registered condominium, the potential for capital appreciation was also enhanced.

The project would not look as attractive in late 1990. At a 13 percent mortgage rate, and allowing for 3 percent vacancy (the prospectus assumed zero), net income would be reduced in the first year to a negative \$370 per unit.

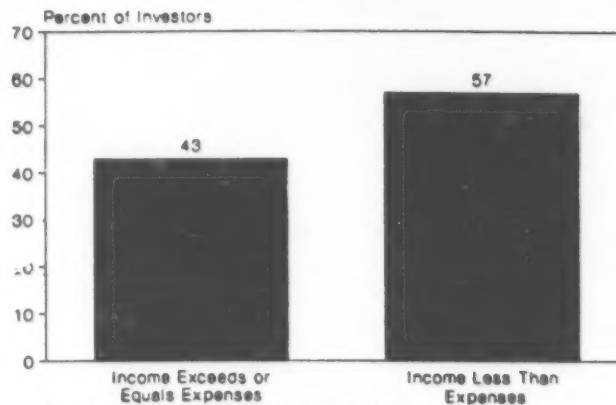
The survey of rental investors in Montreal provides some additional insight into how a sample of recent investors' projects were performing. The survey results were disaggregated to produce separate information for the following types of rental investments:

- Very small apartment building (2-4 units) - the average project cost was just over \$62,000 per unit with current rental income of \$510 per month.
- Small apartment building (5-10 units) - the average cost per unit was \$45,400 with average rental income of \$475 per unit per month. The lower project costs per unit compared to the very small building likely reflect a smaller land cost component given the higher density.
- Medium apartment building (11-50 units) - the per unit costs (\$42,000) and rental income (\$465 per month) are similar to the 5-10 unit building.
- Houses - the average purchase price was \$116,500 and current rents average just under \$1,100 per month. Operating costs are substantially higher than for the apartment projects.
- Condominium units - the average purchase price was \$105,000 and rents averaged \$675 per month.

There was insufficient information provided by investors in very large projects (more than 50 units) to undertake a similar analysis for them.

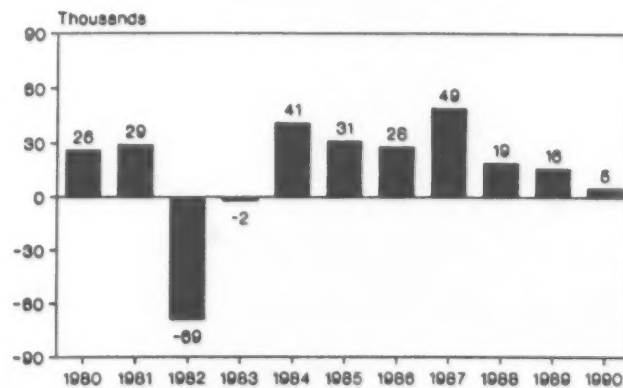
Exhibit 5-16 presents the comparative current performance of these different investor groups. Current net income per unit was substantially negative on average for the investors in lower density units (i.e. very small projects (2-4 units)), houses and

**EXHIBIT 5-17
COMPARISON OF INCOME
AND EXPENSES, MONTREAL**



Source: "Survey of Rental Investors, Montreal".

**EXHIBIT 5-18
EMPLOYMENT GROWTH
MONTREAL, 1980-1990**



Source: Statistics Canada

**EXHIBIT 5-19
NET MIGRATION BY COMPONENT
MONTREAL, 1981-1989**

	Net International	Net Interprovincial	Net Intraprovincial	Total Net Migration
1981-1982	14,336	(15,037)	4,043	3,342
1982-1983	8,644	(17,337)	476	(8,217)
1983-1984	7,259	(13,913)	2,890	(3,764)
1984-1985	7,222	(7,071)	5,368	5,519
1985-1986	8,262	(3,958)	6,043	10,347
1986-1987	19,218	(2,768)	3,343	19,793
1987-1988	19,748	(5,679)	1,266	15,335
1988-1989	22,871	(7,054)	(873)	14,944

Source: Statistics Canada

condominiums.⁵¹ Investors in apartments of 5-10 units and 11-50 units were doing relatively better - they were more or less breaking even on average.

These pro formas provide an indication of the **average** investor performance but not all investors were doing poorly in terms of current net income. Forty-three percent of investors indicated that current income exceeded (30 percent) or was equal to (13 percent) current expenses.⁵²

In summary, the results from Exhibit 5-15 and Exhibit 5-16 confirm that although they may have been a factor for some investors, expectations of short-run returns did not play a major role in the increased rental investment of the mid 1980s.

Industry sources indicate that the "supportable" rents (i.e. to achieve a normal rate of absorption) excluding electricity and heating for new construction were considered to be as follows (for 1990):

	Small wood and brick structure	Concrete Structure of 4-6 Floors
1 Bedroom	\$375-\$500	\$550-\$700
2 Bedroom	\$475-\$550	\$700-\$1,000
3 Bedroom	\$600-\$650	\$800-\$1,200

However, according to the developers who supplied the rental information, these rents do not generally cover expenses. The economic rent for the 2 bedroom concrete structure unit was considered to be in the \$1,200-\$1,300 range; for a 3 bedroom, it was \$1,300-\$1,500. Therefore, developers are increasingly registering larger buildings as condominiums and many are syndications. Without the possibility of future capital gains or the tax shelter write-offs for investors, they would not be building.

5.3 DEMAND FACTORS INFLUENCING RENTAL INVESTMENT IN MID 1980s

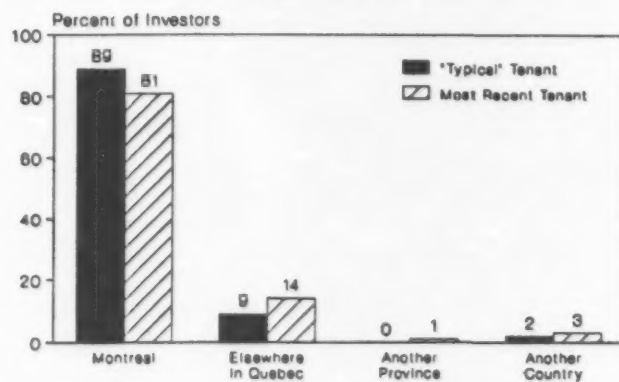
5.3.1 A Strong Economy Spurred Rental Demand

After the recession of the early 1980s, real economic growth rebounded in Quebec during the 1984-1988 period. In Montreal, employment, after declining by over 70,000 jobs in 1982-1983, began to grow again - an average of 37,000 jobs per year were created in the 1984-1987 period. Overall net migration to Montreal picked up substantially over the 1984-1988 period, according to Statistics Canada data, rising from a net outflow of about 8,200 persons in 1982-1983 to a net inflow of roughly

51 The data reflect overall project averages; they are not weighted by unit count within the project.

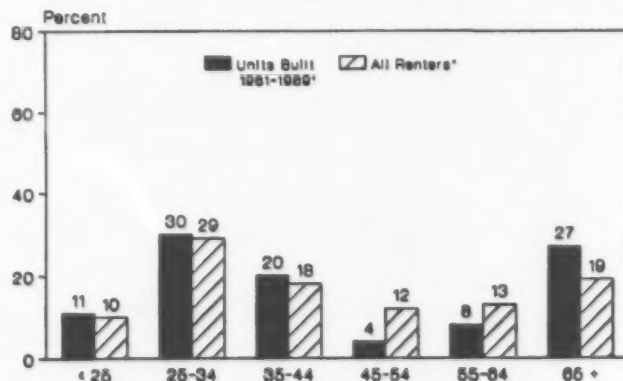
52 These results are based on those respondents who provided complete financial information as well as respondents who were unwilling to provide details but indicated how their revenues and expenses compared.

**EXHIBIT 5-20
ORIGIN OF TENANTS
IN NEW RENTAL UNITS, MONTREAL**



Source: "Survey of Rental Investors, Montreal".

**EXHIBIT 5-21
RENTER HOUSEHOLDS BY
AGE OF HEAD**



* 1989 HIFE data for Quebec centres of 100,000 plus population.
Source: 1989 HIFE data files.

15,000 persons annually in 1985-1989.⁵³ The strong underlying economy and immigration buoyed the demand for rental housing.

New immigrants to any area in general tend to have a higher incidence of rentership. However, in-migrants from other provinces and countries do not seem to be the main source of tenants for new rental units. The survey of rental investors indicated that the vast majority of tenants had moved from the Montreal area (about 80-90 percent), with most of the remainder from elsewhere in Quebec.⁵⁴ However, the influx of migrants undoubtedly contributed to the increase in overall demand for rental housing (including units in the existing rental stock). To the extent that in-migrants were occupying vacated existing units, this would have added to the net increase in demand for rental housing.

The increase in rental demand helped to support higher real rent increases, although these were likely constrained below what they might have been without the influence of the Régie du logement. The higher rents in turn made rental investment more attractive by improving the cash flow situation and prospects for appreciation.

5.3.2 Profile of Renter in Newer Accommodation Similar to All Renters, Although Couples More Common

Little information is available on the occupants of rental units constructed in Montreal in recent years. However, some information exists for occupants of rental units constructed in the 1981-1989 period versus all periods of construction for Quebec centres of 100,000 plus population in aggregate.

Since Montreal represents about three-quarters all renters in Quebec centres of 100,000 plus population and since about 80 percent of units constructed in 1981-1989 were built in the 1985-1989 period, the results are deemed to be highly representative of the profile of tenants in more recently built rental units in Montreal.

Highlights of the information include:

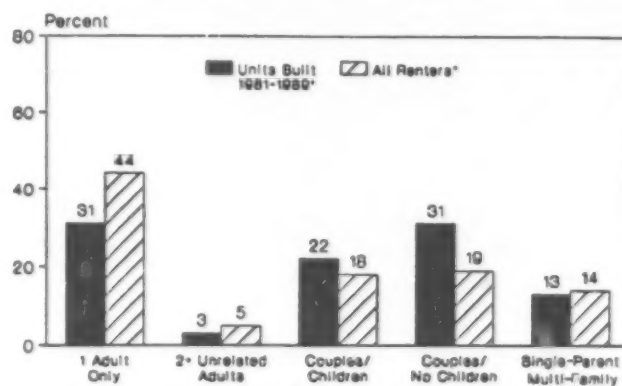
- **Little difference in age profile** - about 60 percent of renter households in more recently constructed units are less than 45 years of age; the proportion for the stock as a whole was only slightly below this.

A somewhat higher proportion of households in newer units, however, were aged 65 plus - this likely reflects the large number of seniors' projects in these years.

53 1989 is the latest year for which these data are available at the CMA level.

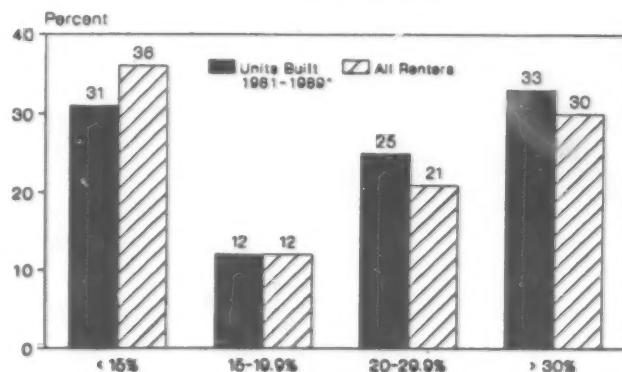
54 Landlords were asked to identify the previous residence of both their "typical" tenant, as well as their "most recent tenant to move into the building". The proportion of tenants who were from the Montreal area was slightly higher for the "typical" tenant than for more recent tenants.

**EXHIBIT 5-22
RENTER HOUSEHOLDS BY HOUSEHOLD
COMPOSITION**



* 1989 HIFE data for Quebec centres of 100,000 plus population.
Source: 1989 HIFE data files.

**EXHIBIT 5-23
RENT/INCOME RATIOS***



* Annualized April, 1989 rent over 1988 household income.
Data are for Quebec centres of 100,000 plus population.
Source: 1989 HIFE data files.

- **Couples more common in newer units** - higher proportions of households in newer units were couples with children (22 percent), and without children (31 percent) than for the stock in general (18 and 19 percent respectively).
- **Affordability comparable in newer units** - renters in newer accommodation in general dedicated somewhat higher proportions of income to rent, however, the difference was not substantial.

5.3.3 A Market For Seniors Was Identified

Most of the larger rental projects built in Montreal in the last half of the 1980s were specialized seniors' projects. These projects accounted for over 90 percent of units constructed in buildings of 50 or more units since 1985. They were aimed at less active seniors, in the over 80 age groups, but were not total care facilities.

These projects have a specialized architecture (e.g. wide corridors to accommodate ambulance stretchers, smaller than average units, but large common areas, etc.) and have optional services available at extra costs (e.g. daily meals, housekeeping services, etc). Because of the specialized nature of these projects, existing buildings are not generally suitable - they are too difficult and expensive to renovate. Therefore, new buildings were constructed to meet the demand.

These seniors' projects supported much higher rents than regular rental units. Typical rents for these projects were as follows:

	Without Services No meals, or Medical Assistance
Bachelor	\$650-\$700
1 bedroom	\$850-\$900
2 bedroom	\$1,000-\$1,200

The costs of additional services such as medical attention vary substantially by project. For meals, in general the cost was \$400-\$600 more per month. An additional person in the unit may also add \$400-\$600 per month.

There was substantial development and promotion of this market for seniors' units in the mid 1980s. There was perceived to be a market niche that up until that time had not been adequately tapped and it was promoted as a growth area by builder groups, government and syndicators. Several promoters established limited partnerships to finance these projects. Encouraged by the climate of speculation that generally motivated investment in real estate, as well as the market niche that was emerging for these projects, many seniors' projects were built in different parts of the Montreal around the same time -too many for the limited size of the market niche.

However, given the time required to organize and construct these large projects, it took many years before the overproduction became evident to investors.

Problems eventually emerged with some of these partnerships. In some projects, the fierce competition meant that economic reality differed substantially from the projections in the prospectuses that were used to attract the limited partners. In a few cases, the promoters underwent criminal prosecution or went bankrupt and the partners lost at least part of their investment or had to contribute additional funds to ensure that the project kept going.

Because of these problems as well as the general overbuilding in the seniors' market, there has been little activity in this sector recently.

5.4 REVIEW OF POTENTIAL FACTORS INFLUENCING ATTRACTIVENESS OF RENTAL INVESTMENT IN MONTREAL

This section presents a review of the importance of each of the major factors influencing the attractiveness of rental investment (identified in Chapter 2 of this study) in the surge of rental construction in Montreal in the second half of the 1980s.

5.4.1 No Incentive Programs to Promote Private Rental Investment

There were no programs from any level of government to promote the construction of private rental housing in Montreal in recent years. These are not considered to be a factor in the increased rental activity in the Montreal area in the second half of the 1980s.

5.4.2 Government Supply Has Been Limited

There was little social housing built in Montreal in the 1980s. Social housing declined even further from its already low levels in the period following 1985 (see Exhibit 5-2). The absence of government supply would generally be positive for private rental supply, in that there would be less competition both for tenants and for land, construction materials and labour.

5.4.3 Interest Rates Returned to More Manageable Levels

After peaking at about 18 percent on average in 1981 and 1982, mortgage rates declined to about the 11¼ to 11½ percent range on average in 1986-1988. These lower, and generally more stable, interest rates provided a generally positive impact to rental investment by improving cash flow on new rental buildings through the reduction of financing payments. The rise in interest rates in the 1989-1990 period

does not appear to have had a significant negative impact on new rental investment in Montreal.

5.4.4 Tax Policies - Capital Gains Exemptions Was Positive For Small Investors

As discussed in Chapter 3, there were several changes in tax policies in the late 1970s and early 1980s which made investment in rental housing less attractive. Since the early 1980s, there have been two significant changes:

- The introduction of, first, the lifetime capital gains tax exemption in 1985 (which was planned to increase to \$500,000 by 1990) and, second, the capping of this lifetime exemption at \$100,000 in 1987 at the same time as the taxable proportion of non-exempt capital gains was increased in stages from 50 percent to 75 percent by 1990.
- The reduction in allowable CCA from 5 percent to 4 percent in 1987.

The lifetime capital gains tax exemption enhanced the attractiveness of investment for individuals. The reduction in allowable CCA and increase in the tax rate of non-exempt capital gains in 1987 would have been a negative factor but is considered unlikely to have outweighed the positive impetus created by the lifetime exemption of \$100,000.

This, plus the improved relative economics of rental projects in Montreal that accompanied the decline in interest rates and increasing rents made the existing tax factors (e.g., use of soft costs and CCA) more attractive. If the relative improvement in other factors enhanced the economics of a given project, but it was still borderline in terms of feasibility, the presence of tax deductions plus the exemption of long-term capital gains would have been sufficient to make a project attractive.

Syndicated rental buildings which largely marketed themselves as tax shelters were not a major player in the rental market upturn of the mid 1980s in Montreal. Although some syndication of rental projects occurred, it was largely in association with seniors' projects; for these projects, the marketing was directed more at the positive net income than tax benefits, though they were clearly a factor as well.

As discussed earlier in this chapter, the survey of rental investors indicated that tax shelter benefits were only a factor in the investment decision for about one-quarter of investors - a mere 3 percent indicated it was the primary factor behind their decision to invest. However, long-term capital appreciation was the major factor and the change in the capital gains tax rules would have been extremely important to these investors.



5.4.5 Rent Controls - The Régie du Logement Has Little Impact on Market Rents

Rent regulation in Quebec is under the jurisdiction of the Régie du logement. The Régie's primary function is to promote conciliation between landlords and existing tenants on both rent and non-rent issues. In assessing the impact of the Régie on rents and on a potential investor's decision on whether to invest in the rental market, the key considerations appear to be the following:

- Rental units in buildings five years old or less are exempt from controls.
- For units in buildings six or more years old, the Régie encourages landlords and existing tenants to negotiate themselves to reach an acceptable agreement on rent increases. To this end, the Régie publishes each year in the major newspapers guidelines which suggest how to calculate a reasonable rent increase. These are based on reasonable rates of increase in each major cost faced by landlords (e.g. actual increases in property taxes and insurance plus a percentage increase for fuel, electricity, maintenance, management costs and interest rates).

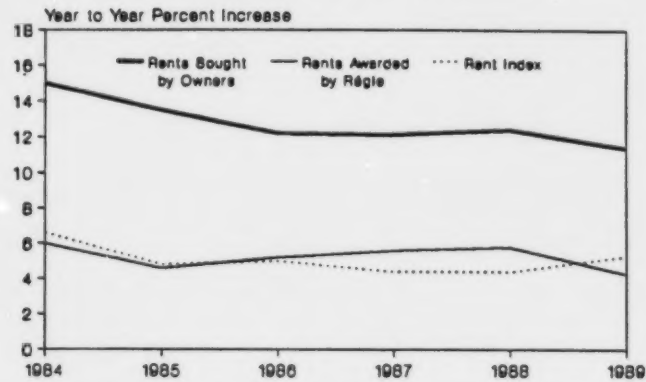
These guidelines are not binding. If the owner is able to negotiate an increase with the tenant which is above (or below) the levels which the guidelines would suggest, this is acceptable to the Régie. If no agreement can be reached, the dispute goes to the Régie for arbitration. In reality, only 2 percent of tenants take this course - and 50 percent of these disputes are settled before the Régie imposes a decision. The rent increase imposed by the Régie would generally be based on the guidelines published previously.

In the cases which have gone to the Régie for a decision on the rent, the average increases requested by the owners have been substantially above those awarded by the Régie.

- Units which are vacated remain legally subject to the rents agreed to with the previous tenants (except for those in buildings five years old or less which are, of course, not subject to controls). New tenants have a legal right to know the rent which the previous tenant paid and increases can be taken to the Régie for arbitration. In practice, however, it appears that landlords generally charge market rents (or close to market rents) for vacant units and tenants do not generally object.

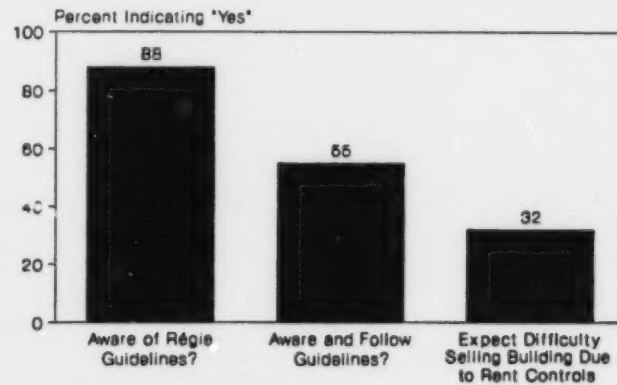
Compared to the rent control programs in operation in other parts of Canada, the Régie du logement appears to present much less of a problem to those investing in the rental market in Montreal. New units are exempt for an initial period so new projects are allowed to achieve rents consistent with the market before they are subject to the Régie; in existing projects, while tenants are protected against large increases in rents which do not result from increased costs, the rents appear generally to be close to what the market would dictate.

**EXHIBIT 5-24
RENTS SOUGHT AND AWARDED
MONTREAL, 1984-1989**



Source: Régie du logement and Statistics Canada.

**EXHIBIT 5-25
RENTAL INVESTORS AND THE RÉGIE
MONTREAL**



Source: "Survey of Rental Investors, Montreal".

Over the 1984-1986 period, the average increase in rents awarded by the Régie was close to that shown by the rent index. In 1987-1988, however, the increases awarded by the Régie were somewhat above the rent index; the situation reversed again in 1989. The suggestion seems to be that the competitive environment of the 1986-1988 period, more so than the Régie, was responsible for the moderate rent increases that occurred over the period.

The rent increase guidelines as published by the Régie appear to be well known but not as widely followed. The survey of investors in Montreal indicated that 88 percent of investors are aware of the guidelines, and of these, about 60 percent said they use the guidelines to calculate their annual rent increases. Therefore, there are a large percentage of new owners who do not follow the guidelines - the 12 percent who are unaware of them, as well as the 33 percent of new owners who are aware they exist, but do not follow them.

That the Régie does not seriously inhibit rental investment appears to be borne out by the survey of rental investors. Although units in newer buildings are not subject to rent regulation, the owners must take into consideration that they will be after 5 years. Yet, only 7 percent of survey respondents indicated that they were very concerned about rent controls when they purchased their rental property. Most (two-thirds) did not feel that the existence of rent controls makes it more difficult to sell their rental property. Moreover, there have been no changes in regulations during the 1980s that would have changed the relative impact of the Régie on the attractiveness of rental investment.

In summary, the system of rent regulation in effect in Quebec may act to reduce rents on existing units modestly below what they might have been in a non-regulated environment, but the ability to pass through costs and negotiate directly with tenants and the exemption of new buildings makes it less detrimental to project viability than the more stringent rent control schemes in operation in some other provinces. In terms of the attractiveness of rental investment in the second half of the 1980s; there were no changes in the Régie's rules in the 1980s which would have enhanced or reduced the attractiveness of rental investment.

5.4.6 Owners Concerned with Other Aspects of Landlord/Tenant Legislation

In terms of landlord/tenant legislation, non-payment of rent appears to be a problem for many owners (especially larger owners). Owners are obliged to approach the Régie when such situations arise and generally must wait at least three months before obtaining approval to sue tenants for non-payment of rent. This problem was cited by most larger owners in the interviews conducted for this study.

Some anecdotal information collected from interviews with large owners and property managers illustrates the situation. One large owner indicated that each month 25 to 30 of his 500 tenants do not pay their rent, and he is obliged to go to the Régie for approval to exact payment. The process takes 3-4 months and he ends up spending

40 percent of the overdue rent collected on the services of a collection agency. Another owner devotes one full-time person just to collect rents and deal with the Régie about persons who do not pay. Some owners interviewed indeed had gotten out of the conventional rental market and into seniors' projects because of the problems encountered in this respect and with the amount of time that had to be devoted to dealings with the Régie.

While the Régie's involvement in non-rent issues adds to costs of management and delays collection of moneys owed, this does not appear to have been a significant impediment to rental investment in Montreal. There were no changes in the regulations in the mid 1980s that would have enhanced or diminished the attractiveness of rental investment.

5.4.7 Condominium Conversion Legislation Not a Major Factor

From 1975 until December, 1987, there was a moratorium on all conversions of rental units into condominium tenure throughout Quebec; in 1982 the ban was lifted on buildings of 5 units or less. In December, 1987, the moratorium on larger buildings was also lifted, except for the municipalities on the Island of Montreal.

As conversions are now permitted in the municipalities in the Montreal CMA which are not on the Island of Montreal, this would have provided some enhancement in the attractiveness of rental investment since the early 1980s for investors who are looking to convert in the future to condominiums before sale.

In general, however, the issue of condominium conversions does not seem to be a major one in the Montreal area. The few conventional large buildings being built are registered up-front as condominiums, even if they are to be rented out for the initial few years. The exceptions are seniors' buildings which are generally not registered as condominiums, given the perceived limited potential for these units as ownership.

From the survey of owners, overall, only 5 percent of owners surveyed indicated that they had registered the building as a condominium, although this proportion was higher for more recently built buildings (i.e. 1989 and 1990) than for those built earlier in the 1980s. Furthermore, only 7 percent of conventional rental owners said if they were to sell the building, they would convert the building to condominiums before selling it, which seems to imply that they do not see greater value in the buildings as condominiums.

To the extent that potential investors may be concerned about regulations on the future sales of their buildings as condominiums, the attractiveness of rental investment appears to have been improved slightly by the lifting of the moratorium on municipalities outside the Island of Montreal. This is, however, considered unlikely to have been a significant factor behind the surge in rental investment in Montreal.

5.4.8 No Major Problems with Restrictive Practices with Regard to Land Approvals, Development Charges, Required Donations and Building Codes

These do not appear to be a major problem with the municipalities in the Montreal area. All municipalities in the Montreal area have pre-zoned land. As long as the land has the correct zoning, the approvals process is a maximum of 3 months which, compared to other parts of Canada, is quite short. If re-zoning is required, the approval may take up to one year. Donations for parkland are required only if a site is subdivided or several adjacent sites are built upon. Development charges are beginning to be imposed in some municipalities in the Montreal area but do not yet appear to be a significant problem for rental investment.

None of the owners interviewed indicated that they had any problems with regard to municipal practices with respect to land development or building codes. To the extent that these are kept to a minimum, it is positive for development costs, and ultimately cash flow for new rental investment, however, there appear to have been no significant changes in these policies since the early 1980s that would have enhanced the relative attractiveness of rental investment.

5.4.9 Lender Policies - Little Changed in the Mid 1980s

The officials interviewed indicated that there were no major changes in lenders policies which would have enhanced rental investment in the mid 1980s relative to the early 1980s. Many, however, indicated that financing had become more of a problem recently.

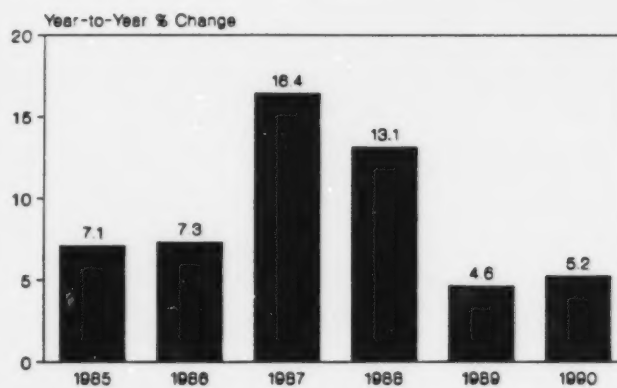
As discussed in Chapter 2, lenders generally determine the proportion of the value of a project they will finance on the basis of the expected income stream. Although lender criteria in this regard do not change per se when interest rates change, higher interest rates effectively increase the proportion of equity that the investor must provide. To the extent that lower mortgage rates than in the early 1980s meant that mortgage payments required less of the rent intake, investors would have been required to put up proportionately less equity.

A recent study conducted for CMHC on the large volume of rental units constructed on the South Shore in Montreal in 1986-1987 found that the following lender practices were prevalent during this period:⁵⁵

- Lenders refused only 10 percent of all projects proposed to them.
- Lenders did not insure the loans in 90 percent of the cases.
- Lenders required market studies for only 50 percent of projects.

55 A study prepared by Raymond Laliberté, Jacques Nobert and Pierre Normandeau of the Université du Québec for CMHC.

**EXHIBIT 5-26
SINGLE-FAMILY LAND PRICES
MONTREAL**



Source: Statistics Canada.

The survey of rental investors conducted for this study indicates that on average rental investors in recent years obtained financing for 75 percent of the project cost.

Although lender criteria per se may not have changed in the mid 1980s, the impact of lower interest rates likely would have reduced the proportion of equity required for a given project from the case in the early 1980s. This would have been positive for rental investment in this period.

5.4.10 Other Factors Also Impacted Rental Investment

5.4.10.1 The strong economy also created a general climate of speculation

It appears that many investors who stayed out of rental and other real estate markets in Montreal in the early 1980s were anxious to invest when economic conditions began to turn around - this was true not only for rental investment, but for other types of investment as well. Although the economics of rental construction may have not been ideal in absolute terms, lower interest rates in the mid 1980s provided some **relative improvement** to the underlying economics of rental construction. This, combined with increased renter demand and marginal increases in real rents, provided fuel for rental investment - particularly for individuals who were also attracted to the more favourable treatment of capital gains.

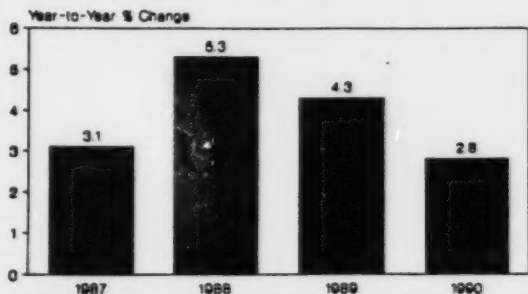
The speculative fever, however, does not appear to have been based largely on expectations of short-term profits. The survey of rental investors indicated that only about 10 percent of investors in this period were primarily motivated by expected profits from sale of the rental property in the short-term (see Exhibit 5-13).

5.4.10.2 Low land costs - a factor behind the proliferation of smaller rental projects

There is little information on trends in multiple land prices during the mid 1980s. However, information on land price trends for single-detached housing provides some insight into likely broad trends; these show double digit increases for the 1987 and 1988 period, with more moderate increases in the period since.

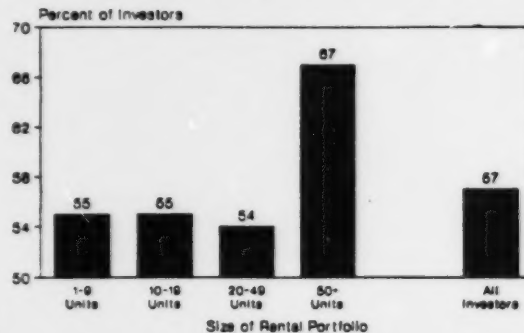
The relative price of land in different municipalities and of different densities contributed to the relative strength of smaller rental buildings in the last half of the 1980s. These smaller buildings were constructed outside of the Island of Montreal. For example, small structures in Laval could be built on land at \$6-\$7 per square foot. On the extremities of the Island of Montreal, land costs were in the range of \$10-\$12 per square foot for small buildings and \$20-25 for larger, higher-density projects. Little rental construction has occurred since the mid 1980s in the centre of

EXHIBIT 5-27
APARTMENT CONSTRUCTION PRICES*
MONTREAL



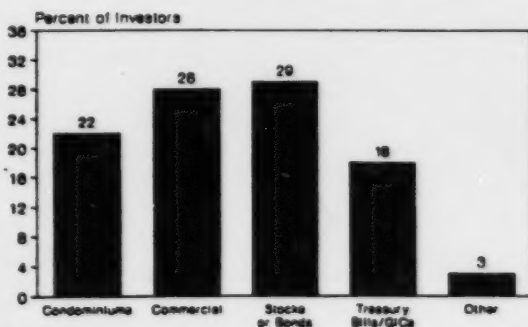
* Based on contractors selling prices, assuming they were bidding on a 7-storey, reinforced concrete apartment structure with 60 units. Land and "soft" costs are excluded.
Source: Statistics Canada

EXHIBIT 5-28
CONSIDERED ANY ALTERNATIVE
TYPES OF INVESTMENTS, MONTREAL



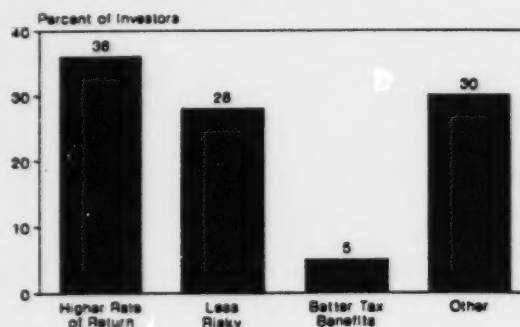
Source: "Survey of Rental Investors, Montreal"

EXHIBIT 5-29
TYPES OF ALTERNATIVE INVESTMENT
CONSIDERED, MONTREAL



Source: "Survey of Rental Investors, Montreal"

EXHIBIT 5-30
REASONS FOR CHOOSING RENTAL
INVESTMENT, MONTREAL



Source: "Survey of Rental Investors, Montreal"

Montreal, where land can cost up to \$100 per square foot; land costs in this area will only support luxury condominium construction.⁵⁶

The **availability** of land for rental was not a problem in 1985-1990, although many of those interviewed indicated that land was becoming too expensive to be used as rental. Also, a substantial proportion of new rental construction took place on land which the developer had already owned for some time.

5.4.10.3 Construction costs - kept down by building smaller projects

Information on apartment construction costs indicate that only moderate year-to-year increases occurred in the mid 1980s. Relative costs for smaller versus larger buildings, however, encouraged the construction of smaller buildings. Using the information from the pro forma presented earlier (see Exhibit 5-15), the relative construction costs per square foot for the three types of rental projects in the late 1980s were as follows:

Walk-up	\$35
High-Rise	\$46
Seniors	\$62

Correspondingly, rents can be substantially lower for the small buildings, while still providing an attractive return from an investment point of view.

5.4.10.4 Most investors found alternative investments to be more risky and provided lower rates of return

The survey of rental investors indicates that more than 40 percent of investors in rental housing since 1985 did not seriously consider any alternate types of investments; the remainder considered at least one alternate type of investment before investing in rental housing. Investors with larger portfolios (50+ units) were more likely to have considered alternative investments. The alternate types of investments most often considered were stocks or bonds and commercial property.

The most often cited reasons for choosing to invest in rental housing were the perceived higher rates of return and the perception that this type of investment was less risky. Preferential tax benefits associated with rental housing were only a significant factor for 5 percent of those considering alternate investments; this proportion was higher for investors with larger rental portfolios.

The perception of investment in rental housing as being less risky appears to be at least partially related to the fact that many investors had previous experience in the rental market. The interviews with larger developers indicated that even though the

56 This is similar to the situation in Vancouver (as discussed in Chapter 6).



rental market was currently in a downturn, they would stick with it, because this is what they know best - they intended to wait it out until things improve.

5.5 WHY DID RENTAL INVESTMENT SURGE THEN CONTINUE STRONG WHEN THE MARKET WAS CLEARLY WEAKENING?

The foregoing discussion identified the major factors behind the surge in rental investment in Montreal in the second half of the 1980s. There were no major changes in the regulatory environment, lender policies or government incentive programs which could explain the large increase in rental housing activity starting in 1985. However, there were several factors which help to explain the obvious increase in the attraction of investors to rental housing in Montreal:

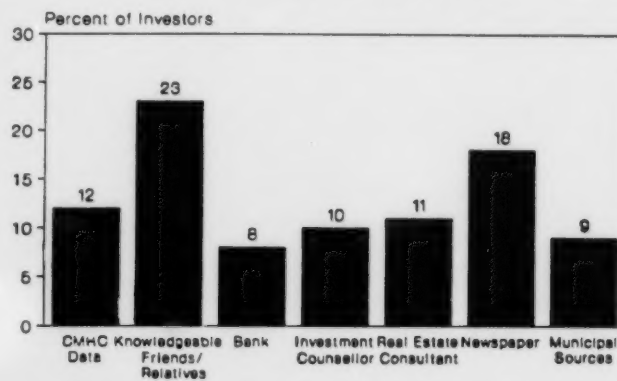
- The improvement in the economy and increased net migration stimulated the demand for housing and led to a decline in vacancy rates.
- Real rents began to rise modestly.
- The reduction in mortgage interest rates from the very high levels of the early 1980s improved both the short- and long-term viability of rental investment.
- A market niche emerged; in seniors' rental housing projects.
- The change in the capital gains tax provisions to allow a lifetime exemption for up to \$100,000 in capital gains attracted individuals to the rental market. The low cost and availability of land and prominence of small buildings were ideal for small investors.
- The fever of speculation which characterized the post-recession period (likely partly due to the changes in the capital gains tax provisions) provided fuel for investment in attractive ventures.

If these explain the surge in rental investment in the early part of the period, however, the question arises of why investment increased further in 1987 and continued to be strong in the face of increasing vacancy rates and declining rates of rent increases? The answer appears to relate to a lack of awareness of market signals on the part of at least some investors and continued faith in the long-term prospects for rental investment. This section explores these issues.

5.5.1 Increase in Vacancy Rates in Early 1987 Not Substantial Enough to Dampen Investment

The CMHC vacancy rate in October, 1986 was 1.8 percent. To investors, this indicator would have been considered to be positive. The April, 1987 vacancy rate

**EXHIBIT 5-31
IMPORTANT SOURCES OF
INFORMATION*, MONTREAL**



* Percent indicating source was "important" or "very important".
Source: "Survey of Rental Investors, Montreal".

was comparable (1.7 percent) - there was not yet any signal that problems were emerging. By the time the October, 1987 vacancy survey results were released in late 1987, and revealed a substantially higher vacancy rate of 3.6 percent, rental starts had reached an annual rate of over 17,000 units and, according to industry officials, sales were still high for rental buildings which were not yet started.

5.5.2 Also Communication Problems with Vacancy Rates

Vacancy rates continued to rise since October, 1987, a signal to investors that it might be time to cut back on new investment in rental housing. Indeed the lower starts levels over the next few years indicate that many did so.

It appears, however, that the CMHC vacancy rates are not widely consulted as part of the decision making process (see Exhibit 5-31). The survey of rental investors indicated that only 12 percent of investors said that CMHC information on rents and vacancy rates were at all important factors in their decision to invest - only 3 percent said they were very important. Even for those who do take the CMHC information into consideration, however, it is not necessarily giving them the information that is relevant to their situation, as the generally published vacancy rates do not include rates in more recently constructed buildings, where vacancy rates are generally substantially higher.

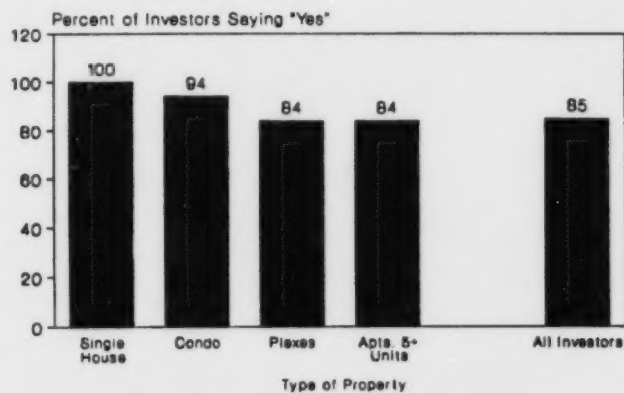
The fact that rental construction did decline to some degree, even if vacancy survey results are not widely consulted, indicates that the information on rising vacancies was getting through in other ways - such as in the press, by word-of-mouth and, likely, personal experience.

5.5.3 Investors Generally Use Their Own Judgment Rather Than Outside Sources of Advice

It appears that the average rental investor in Montreal, particularly one investing in smaller buildings, does not rely heavily on outside sources of information in his approach to the decision-making process. Few seek the advice of banks, investment counsellors or real estate consultants. Rather they rely more heavily on the press, knowledgeable friends or relatives, and most importantly, their own feel for what is happening, particularly if they are investing in a sector of Montreal that they are familiar with.

To the extent that many investors utilize soft information, such as the successes of others they know or earlier successes they themselves had, rather than any comprehensive assessment of the rental market in making their decisions, could explain why investment continued at relatively high levels despite adverse market conditions.

**EXHIBIT 5-32
MADE A GOOD DECISION IN BUYING THE
RENTAL PROPERTY, MONTREAL**



Source: "Survey of Rental Investors, Montreal".

5.5.4 Demand Remained Relatively Strong

Although vacancy rates rose continuously between October, 1987 and 1990, they did not increase dramatically despite the large volume of new construction. This suggests that underlying demand remained relatively strong. The exception was in the seniors' market where demand was lower than anticipated and overbuilding and the unsuitability of some projects in terms of amenities/services offered contributed to a significant oversupply.

5.5.5 The Perception of Rental Housing as a Good Investment Vehicle Persists

The deterioration in the short-term attractiveness of rental investment due to higher interest rates and weaker demand suggests that those investing still expected long-term gains. Despite less attractive conditions, investors who had recently developed or purchased rental housing were generally not pessimistic. The vast majority (85 percent) of respondents to the survey of rental investors indicated that they felt they had made a good decision in buying their rental property even though most were not generating positive net income.

This sentiment was also reflected among the larger developers. Most intended to hang on to their buildings for some time; others regretted that buildings which had been sold to other companies and individuals in the past had not been kept for their own portfolio.

5.5.6 Reduction in New Rental Investment Expected in Montreal

Despite the continued optimism of many of the investors who responded to the survey, new rental investment is expected to decline in Montreal over the next year or two. Key factors in this decline are:

- High and rising rental vacancy rates.
- A slowdown in the economy which should result in a further decline in the demand for new rental housing.
- Recent incentives provided by the provincial and several municipal governments to promote homeownership.
- Declining real rents - the gap between what the rental market will accept and the economic rents on new buildings indicates that most new buildings will face a negative cash flow for some period.
- More reluctant lenders - investors indicate that lenders are requiring increasingly onerous guarantees.



These factors point to a significant decline in rental investment in Montreal in 1991 and likely 1992 despite the decline in interest rates in 1991. However, to the extent that many of the investors in the rental market are unsophisticated and do not respond as readily to the signals of the market, the decline in rental investment may be less pronounced than might be expected. These investors have ignored the market signals of the past few years with the result that vacancy rates continue to climb; it is unlikely that they will ignore them forever.

In the longer-term future, with an economic recovery and increasing demand for rental housing in the period following the current recession, there is no reason to expect that rental investment will not resume in Montreal when vacancy rates decline and real rents again begin to increase.

5.6 CONCLUSION

Montreal was selected for analysis in this study because it did not appear to conform to the theoretical operation of the housing market as outlined in Chapter 2 of this study: Montreal has rent controls but, despite this, a great deal of rental housing was built in the second half of the 1980s; indeed, building continued even when a looming oversupply was apparent.

In terms of the criteria established for assessing **efficiency** in the rental market (Section 2.4), there is little evidence to suggest that investors were acting irrationally in Montreal in the late 1980s. While market signals such as rising vacancy rates indicated that the climate for new rental investment would be less promising, the actual economics of investment in the type of small projects that characterize the Montreal market were reasonable. Investing in a project with a small negative cash flow in the early years is not irrational if the alternatives (e.g., building condominiums or holding vacant land) are poor, especially if there are expected capital gains and/or the losses can be written off against other income. Investors, mostly small operators, many with experience in the rental market, were simply cashing in on the long-term gains which they believed were available from rental housing investment.

In terms of government interventions which may be leading to inefficiencies in the market, Montreal appears to have some lessons to teach other Canadian jurisdictions. One of the key factors in the ample supply (and attractive economics) of rental housing is the availability (and reasonable price) of developable land. This dampens speculative activity and promotes stability in the market. Also, the operations of the Régie du logement appear to achieve the desirable balance between protecting the interests of both tenant and landlord while still allowing the market to operate effectively.

EXHIBIT 6-1

PRIVATELY INITIATED RENTAL APARTMENT
COMPLETIONS BY SIZE OF STRUCTURE
VANCOUVER, 1970-1989

	<u>Under 6</u>	<u>6-19</u>	<u>20-49</u>	<u>50-199</u>	<u>200 +</u>	<u>Total</u>
<i>Average Annual Number of Units</i>						
1970-1979	67	284	1,708	2,307	269	4,635
1980-1984	31	268	1,193	1,883	53	3,428
1985-1989	25	108	278	601	41	1,053
<i>Percent Distribution</i>						
1970-1979	1	6	37	50	6	100
1980-1984	1	8	35	55	2	100
1985-1989	2	10	26	57	4	100

Source: CMHC.

CHAPTER 6

THE VANCOUVER RENTAL MARKET

In B.C., rent controls ended in 1983 and since late 1988 the market in Vancouver has been characterized by low vacancy rates and significant rent increases. Despite these positive influences for rental supply, new private conventional rental production has been limited. This chapter examines the operation of the rental housing market in Vancouver.⁵⁷ As with the other centres examined in this study, the emphasis is on the supply side of the market. The chapter includes an overview of recent trends in the Vancouver rental market, an examination of the rental supply industry and an analysis of the demand and supply factors currently affecting the market. The analysis is intended to identify the reasons why private new conventional rental production remains limited. The analysis is based on a review of available information, a series of interviews with developers and others knowledgeable about the rental housing industry, government sources and a survey of recent investors in non-conventional rental housing in Vancouver.⁵⁸

6.1 OVERVIEW OF RECENT TRENDS IN THE VANCOUVER RENTAL MARKET

6.1.1 Conventional Rental Production Declined in the Latter Half of the 1980s

As in other rental markets across Canada, a variety of factors including interest rates, the economic slowdown (which was very severe in western Canada) and less favourable tax treatment of rental housing combined to lessen the attractiveness of rental investment in Vancouver in the early 1980s relative to the 1970s. At the same time, the poor economy led to reduced rental demand; the result was that average annual private rental production in the first half of the 1980s declined by over 25 percent from the levels of the 1970s.⁵⁹

Rental production declined even further in the second half of the 1980s - despite the fact that rent controls began to be phased out in the late 1970s and were entirely eliminated in B.C. in 1983. Private rental apartment completions, which averaged about 3,400 units per year in the 1980-1984 period, dropped to only about 1,000 units per year in 1985-1989.

57 The discussion and analysis refer to the Vancouver Census Metropolitan Area.

58 Details on the survey of rental investors are presented in a separate volume, Appendix B.

59 Two different series are used to illustrate the level and composition of rental construction in the 1980s. The first series, (Exhibit 6-1) is CMHC data on "private" rental apartments completions by size of structure (some co-op units are included). The second (Exhibit 6-2) is total rental starts (which includes both row and apartment and publicly and privately initiated units). This latter series is only available since 1982 and does not contain a breakdown by size of building.

**EXHIBIT 6-2
RENTAL STARTS BY INTENDED MARKET
VANCOUVER, 1982-1990**

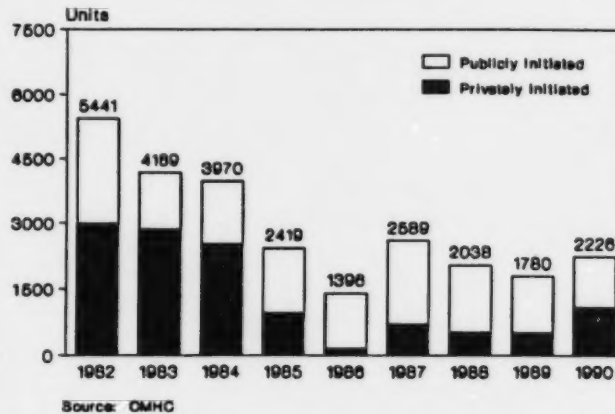
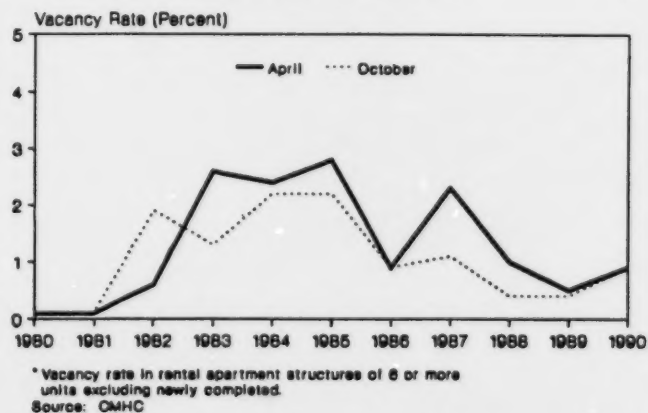


**EXHIBIT 6-3
RENTAL APARTMENT VACANCY RATE-
VANCOUVER, 1980-1990**



Information on rental starts indicates that the relative decline in private rental starts was more pronounced than total starts. Since 1986, the bulk of newly-built conventional rental housing has consisted of publicly-initiated housing - about three-quarters of the average total rental starts of about 2,100 units per year. In 1990, private starts increased modestly to just over 1,000 units (mainly apartments) from an average of less than 500 units annually in 1986-1989.

Completions of all sizes of rental buildings declined in the latter part of the 1980s but there was little change in the distribution of buildings by size from the previous 15 years. The share of small rental apartment buildings (less than 20 units), while increasing modestly in recent years, has never accounted for a large part of the Vancouver rental market.

6.1.2 Low Construction Levels Contributed to a Shortage of Rental Accommodation in 1987-1990

Prior to the economic upturn of the late 1980s, rental accommodation in Vancouver had been in plentiful supply - with the exception of the Expo year (1986). The rental apartment vacancy rate exceeded 2 percent in 1984, 1985 and early 1987. However, the rental housing market in Vancouver tightened considerably in the late 1980s in response to low volumes of construction of new conventional rental housing and increased demand. Vacancy rates in privately-initiated rental apartment buildings declined from 2.3 percent in April, 1987 to 0.5 percent in 1989. The market eased slightly in 1990 - vacancy rates in both April and October of 1990 were 0.9 percent. In April, 1991, the vacancy rate increased to 2.3 percent which is indicative of a reasonably balanced market.

6.1.3 However, CMHC Vacancy Rates Do Not Cover the Whole Market

There is a question whether the rental market in Vancouver was as tight in the 1987-1990 period as the CMHC vacancy data indicated. While CMHC rental vacancy information is the most comprehensive available indicator of trends in the rental market, it has some shortcomings as an indicator of the overall availability of rental accommodation which are particularly important in Vancouver:

- **It does not cover all forms of rental accommodation** - the survey covers units in rental apartment structures of six or more units and rental townhouse projects; excluded therefore are smaller apartment buildings, rented single-detached houses, rental units in primarily owner-occupied strata-titled buildings and secondary suites.
- **It has a restrictive definition of vacancies** - for a unit to be considered vacant, it must be physically unoccupied and immediately available for rent at the time the survey is conducted; excluded, therefore are rental units which are available for lease at some point in the future. In tight rental

EXHIBIT 6-4

RENTAL HOUSING STOCK SURVEYED BY CMHC VANCOUVER

Type of Unit	CMHC* April 1986	Census** June 1986	CMHC as % of Census
	<i>Units</i>		
Apartment	114,759	157,715	73
Row (Townhouse)	8,445	14,485	58
Single-detached, Semi-detached, Duplex and Other	0	58,450	0
Total	123,204	230,650	53

* Privately-owned and publicly initiated rental stock (occupied plus vacant).

** Occupied rental stock.

Source: CMHC and Census of Canada.

EXHIBIT 6-5

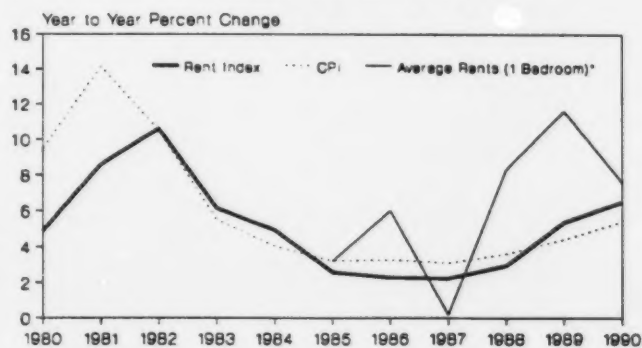
INDICATORS OF RENTAL HOUSING AVAILABILITY VANCOUVER*

	CMHC Vacant Units April, 1990		R.H.C.B.C. Places to Rent (Units) March, 1990
Apartment	1,020	Apartment	1,768
Row	18	House/Townhouse	1,061
Total	1,038		2,829

* Includes privately-owned rental units only.

Source: CMHC and Rental Housing Council of B.C. (R.H.C.B.C.).

**EXHIBIT 6-6
RENTS AND INFLATION
VANCOUVER, 1980-1990**



* October rents
Source: Statistics Canada and CMHC.

markets such as Vancouver, most rental units are leased to new tenants long before they become physically vacant.

The CMHC rental vacancy survey covered just over one-half of the total rental stock in the Vancouver CMA in 1986. While the survey covered roughly three-quarters of all rental apartment units, it included only about 60 percent of rental row units and none of the 25 percent of the rental stock (in 1986) which was neither apartments nor row units.

Information from the Rental Housing Council of B.C. (RHCBC) suggests that the number of rental units available for rent, as advertised in newspapers in March 1990, was close to three times the number indicated by CMHC in its April, 1990 survey. Since CMHC surveys roughly one-half of the entire rental stock, these additional vacant units suggest the "true" vacancy rate for the total rental stock was significantly higher than the CMHC figure.

Less easy to quantify are the numbers of rental units that become available for rent but do not reach the newspapers or become physically vacant only momentarily. "Word of mouth" from one friend or business colleague to another is a common way for prospective tenants to find accommodation.

6.1.4 Non-Conventional Sources of Supply Are Substantial

The primary source of additional rental housing in the 1985-1989 period was not through conventional sources but through the rental of houses and condominiums and the creation of secondary suites. It is estimated that 5,700 rental units per year were added from these sources - or three-quarters of total additional supply.⁶⁰

In summary, while the rental market in the Vancouver area was tight in 1987-1990, the overall available supply of rental accommodation was not as constrained as popularly perceived - or as indicated by the CMHC vacancy estimates.

6.1.5 The Tight Rental Market Led to Increasing Rents

Rent controls were phased out in B.C. beginning in 1978 (as rents for units reached a certain threshold, units became uncontrolled); they were entirely removed in 1983. Although there were fears at the time that rents would increase rapidly with the removal of rent controls, this was not the case. The weak economy at the time plus the completion of a substantial number of new conventional (MURB and CRSP) rental units and new condominium units which could not be sold and so were put onto the rental market combined to keep vacancy rates high; this, combined with lower rates of inflation, kept rent increases in check.

60 The assumptions behind this estimate are discussed in Section 6.2.

The improved economy and subsequent tightening of the rental market in the latter 1980s, however, translated into higher rent increases. The CMHC series on average rents shows that rents for a 1 bedroom apartment increased by about 12 percent between October, 1988 and October, 1989 - this compares to an 8 percent increase in 1988 and almost no increase in 1987. According to CMHC, rent increases eased somewhat in 1990, to 7.6 percent in the 12 months ending October but this was still above the rate of inflation. The increases shown by the Statistics Canada rent index series are substantially less, but nonetheless show increases for 1989 and 1990 which are above the rate of inflation.

6.1.6 The Question: Why Has Private Rental Construction Not Increased Despite Low Vacancy Rates and Rising Real Rents?

As outlined in Chapter 2, the theory is that declining vacancy rates and rising real rents should make rental investment more attractive to potential investors and increase the supply through the provision of additional rental units - particularly in an environment free of rent controls.

Vacancy rates in Vancouver contracted substantially in the late 1980s and real rents were rising in this period. Yet conventional rental apartment construction remained very low. Why?

6.1.7 The Answer: There Was Substantial Non-Conventional Rental Investment, But a Combination of Factors Have Worked Against Conventional Private Supply

Clearly, from the foregoing analysis, there was a substantial volume of new rental supply put onto the market in Vancouver in the second half of the 1980s. However, the new supply was mainly comprised of non-conventional rental units (houses, condominiums and secondary suites). There are a variety of reasons behind the lack of new conventional private construction in Vancouver. These are addressed in the remainder of this chapter.

6.2 THE SOURCES OF RECENT RENTAL INVESTMENT IN VANCOUVER

There is little comprehensive information on the structure of the rental housing industry in Vancouver. But this is important in analyzing the reasons behind the supply response (or lack thereof) to the market signals of the last half of the 1980s. The analysis in this section relies heavily on discussions with individuals involved in the supply of conventional rental housing, either directly (i.e. developers, property managers, etc.), or indirectly (i.e. government bodies), a survey of investors in non-

EXHIBIT 6-7 **INVESTORS IN RENTAL HOUSING** **VANCOUVER, 1985-1989, UNITS**

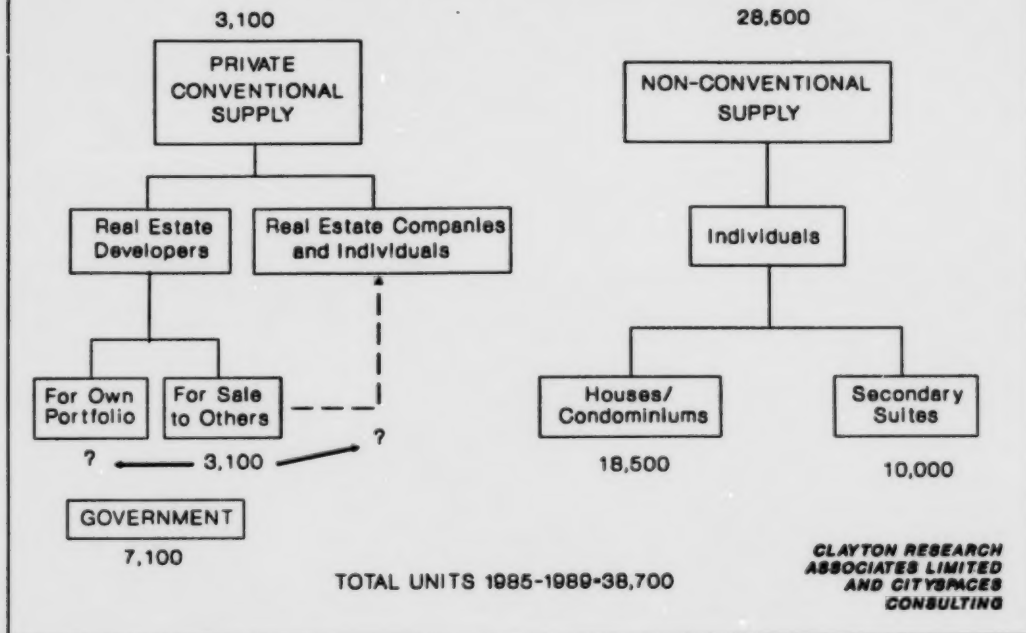


EXHIBIT 6-8

ESTIMATES OF NUMBERS OF SECONDARY SUITES

Jurisdiction	Data on Number of Suites	Source
City of Vancouver	A total of 26,000 secondary suites in 1986, up by about 20,000 suites from a decade earlier; equivalent to 39% of all housing in RS-1 areas.	W.T. Stanbury and John D. Todd, "The Housing Crisis: The Effects of Local Government Regulation", January, 1990.
District of Surrey	A total of 5,365 secondary suites as at December, 1989 assuming 10% of all single-family dwellings have secondary suites.	Manager's Department, City of Surrey, "Secondary Suites", December, 1989.
District of North Vancouver	A total of about 2,000 secondary suites; equivalent to about 15% of all single-detached houses.	Social Planning & Research Council of British Columbia, "Housing Needs in the District of North Vancouver", October, 1989.

conventional rental housing, and interviews with other persons knowledgeable about the provision of rental housing in Vancouver.⁶¹

6.2.1 Little Conventional Rental Production in 1985-1989 But Significant Non-Conventional New Supply

The total increase in the rental housing stock in the 1985-1989 period in Vancouver is estimated at 38,700 units - or just over 7,700 units on average per year.

Suppliers of private conventional rental housing provided only a minor share of new rental housing supply in the 1985-1989 period. A total of only 3,100 rental starts were attributed to this group, or less than 10 percent of the total increase in the stock. Some of these would have been kept by the developers for their own portfolio, while others were sold to investors - the relative proportions of each are unknown. Although there was a modest shift towards smaller rental apartment buildings in the 1985-1989 period (see Exhibit 6-1), the bulk of the (relatively small number) of new private, conventional units were in buildings of 20 or more units; over 60 percent were in buildings of 50 or more units.

Publicly-initiated supply amounted to 7,100 units in 1985-1989, or 18 percent of the total supply. Total conventional supply, therefore, was 10,200 units for the period, or just over 2,000 units per year.

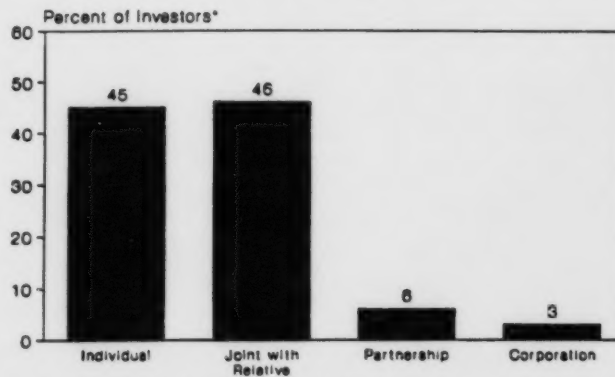
Investors in non-conventional rental housing accounted for almost three-quarters of the additions to the stock of new rental housing in the 1985-1989 period. Investors renting out houses and condominiums were the single most common group of investors - they accounted for an estimated additional 18,500 units (3,700 units per year). The creation of secondary suites was also important - an estimated 10,000 units for the five year period (2,000 units per year).⁶²

61 The survey results reflect the responses of just over 500 owners of non-conventional rental housing units (i.e. single-detached homes, condominium units, secondary suites). The detailed results are provided in a separate volume, Appendix B.

62 Comprehensive data on additions of non-conventional rental housing to the stock are not available. However, Clayton Research Associates and CitySpaces Consulting have prepared estimates of this component of additional rental supply. It must be emphasized that these estimates are based upon a review of available incomplete information and the consultants' understanding of the housing market. However, care was exercised to be conservative in their estimation.

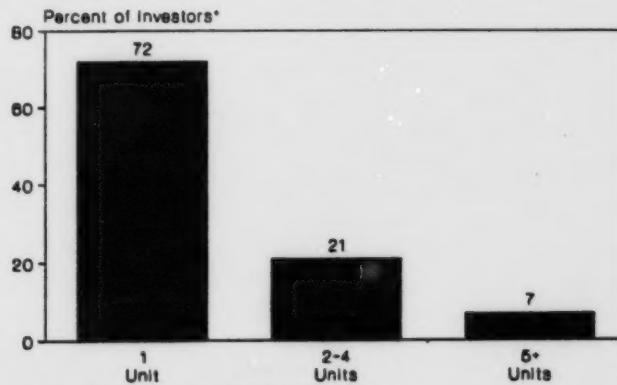
Investors are attracted to the purchase of houses (both new and existing) and condominiums in a rising housing market by the expectation of sizeable gains; the reverse, of course, is true when prices are stable or declining. Data from the Census of Canada support this assessment: as a result of the last housing boom in the Vancouver area (1979-1981), the number of renter-occupied single-detached houses increased significantly; by an average of nearly 2,000 per year for the 1976-1981 period as a whole. The decline in the market in the early 1980s, however, saw this level fall to only about 300 per year for the 1981-1986 period. Rising house prices since that time suggest that this annual number increased substantially, as additional investors entered the market. It is estimated that there was a gross addition of 1,900 single-detached units to the rental stock per year over the 1985-1989 period - considerably

**EXHIBIT 6-9
TYPE OF OWNERSHIP
VANCOUVER**



* Investors in non-conventional rental units.
Source: "Survey of Rental Investors, Vancouver".

**EXHIBIT 6-10
SIZE OF RENTAL PORTFOLIO
VANCOUVER**



* Investors in non-conventional rental units.
Source: "Survey of Rental Investors, Vancouver".

6.2.2 A Variety of Types of Rental Investors

A variety of actors appear to be involved in investment in private conventional rental housing. Members of the following groups have either built housing or are considering it:

- **Corporate and Family builder/developers of long standing** - these may have an advantage over many of the others in that they have generally held some land for a substantial period of time; they generally build for their own portfolio.
- **Newer developers** - these generally build to sell at some stage, depending on market conditions; this group includes potential syndicators.
- **Specialty groups** - such as the Vancouver Land Company (VLC). The VLC is a private for-profit development firm established in 1989 with the assistance of the Vancouver City Council to build rental housing on City owned land on a long term (80 year) lease arrangement.
- **"Amateurs"** - these have been mainly attracted by the B.C. Rental Supply Program subsidies, but are generally discouraged by lenders.
- **Purchasers** - these include both those buying new buildings from developers and those buying existing buildings.

Although these groups were all currently active in the rental market in the late 1980s and 1990, their relative importance is not known.

To examine the profile of investors in **non-conventional** housing, a survey was conducted of owners renting out houses, condominiums and secondary suites.⁶³ The conclusions from the survey include:

- **Few non-conventional units supplied by larger firms** - almost 50 percent of units were owned by individuals; about the same proportion were

above the 1981-1986 period, but somewhat below the level experienced in the latter 1970s.

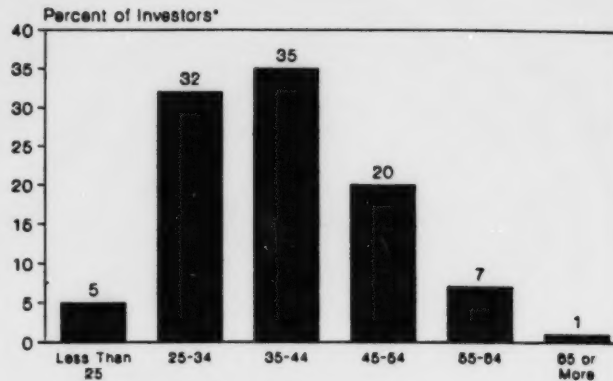
For condominiums, while exact numbers are not available, conversations with market observers indicate that roughly one-third of new condominiums in recent years were purchased by investors. Applying this proportion to the number of condominiums completed between 1985 and 1989 produces an average of about 1,800 additional rental units per year from this source.

For secondary suites, "hard" data are not available for the entire Vancouver area. However, it is suggested that a net addition of 2,000 units per year on average would be conservative. According to a study by Stanbury and Todd, the City of Vancouver alone had this number of secondary suites added annually during the 1976-1986 decade (see Exhibit 6-8).

Therefore, the estimated total gross number of non-conventional units added to the Vancouver rental stock in the 1985-1989 period is 28,500 (Exhibit 6-7). This, combined with the 10,200 units of conventional supply results in total rental supply of 38,700 units.

63 The sample was drawn from classified ads in the Vancouver Sun for selected dates in the April to August, 1990 period; 55 percent of the sample rented houses, 30 percent had secondary suites and 16 percent were renting condominiums.

**EXHIBIT 6-11
AGE OF INVESTOR
VANCOUVER**



* Investors in non-conventional units.
Source: "Survey of Rental Investors, Vancouver".

EXHIBIT 6-12

**AVERAGE PROJECT EXPECTED PERFORMANCE
BCRSP APPLICANTS, VANCOUVER***

	Approved Projects	Other Applicants
Average Project Size (Units)	49	76
Average Unit Size (Sq. Ft.)	830	925
Mortgage Rate (%):		
Market	13.0	13.0
Effective with subsidy	8.0	8.0
Project Cost	(\$ per unit)	
Land	27,500	34,500
Construction and Soft Costs and Profit	87,000	95,000
Total Project Cost	114,500	129,500
Project Financing:		
Total Project Cost	114,500	129,500
Mortgage	82,800	97,500
Equity	31,700	32,000
First Year Revenues and Costs		
Revenues		
Gross Income**	9,250	10,900
Operating Costs***	2,315	2,725
Net Operating Income	6,935	8,175
Mortgage Payment:		
Without Subsidy	10,950	12,900
With Subsidy	7,585	8,930
Net Income:		
Without Subsidy	(4,015)	(4,725)
With Subsidy	(650)	(755)

* Excludes VLC Properties projects.

** Based only on rental income; to compensate for lack of information on other income sources, vacancies were assumed to be zero.

*** Estimated at 25 percent of gross income.

Source: CitySpaces Consulting and Clayton Research Associates based on BCRSP files.

owned jointly between relatives. Partnerships and corporations comprised only a small proportion of investors in non-conventional rental housing.

- **Most owned only the one unit** - almost three-quarters of those surveyed indicated that they owned only the rental unit that was advertised. Less than 10 percent owned 5 or more rental units.
- **Two-thirds of investors aged 25-44** - two out of three suppliers of non-conventional rental housing in Vancouver were in the 25-44 age group - this was split about equally between the 25-34 and 35-44 age groups.
- **Few owners are full-time landlords** - almost 90 percent of owners indicated that they had full-time employment in some occupation other than being a landlord. Not surprisingly, the minority of owners who had larger rental portfolios were more likely to be full-time landlords.

6.2.3 Short-Run Returns Do Not Generally Support Conventional Rental Construction

Information from the B.C. Rental Supply Program (BCRSP) provides some insight into the economics of conventional rental construction in Vancouver in 1990. The program offers developers of new private rental accommodation a subsidy for the initial five years of the project which equaled the differential between actual financing costs under actual mortgage rates and "the rate at which the proposed project is viable" (no lower than 8 percent).⁶⁴

Information was distilled from BCRSP files to show the average expected financial performance of the projects for which developers applied for assistance under the Program, both on a subsidized and unsubsidized basis. Results are shown for successful versus unsuccessful applicants separately. The following typify the average project:⁶⁵

- **Successful Applicants** - the average project was 49 units, with average unit size of 830 square feet and initial rent of \$770 a month. The average total cost per unit was \$114,500. Without the subsidy, the average project is not very attractive - the net income in the first year associated with the average 13 percent mortgage rate prevailing in 1990 was a negative \$4,000 per unit. With the subsidy (i.e. effective mortgage rate of 8 percent), the average project would exhibit a marginal first year loss per unit.⁶⁶

64 Quote is from the call for applications; the Program is discussed in more detail in 6.4.1.

65 The "average" project was generated by calculating the average values for each variable. Projects developed by the Vancouver Land Company are excluded from the analysis, as they incorporated leased land. The information incorporated applications up to mid 1990.

66 Although subsidies were available up to the equivalent of an 8 percent mortgage rate, not all developers indicated that they needed the 8 percent rate for the project to be "viable"; most did, however, so that the average was just slightly over 8 percent.

EXHIBIT 6-13

DISTRIBUTION OF SAMPLED BCRSP
APPLICATIONS BY MUNICIPALITY

Municipality	Projects		Units	
	Number	Percent	Number	Percent
Burnaby	9	12	520	10
Coquitlam	2	3	263	5
Delta	1	1	46	1
Langley	3	4	76	2
Maple Ridge	5	7	389	8
New Westminster	7	9	1,160	23
North Vancouver	5	7	158	3
Pitt Meadows	4	5	145	3
Port Coquitlam	2	3	102	2
Surrey	13	17	1,187	24
City of Vancouver	25	33	969	19
Total Sample	76	100	5,015	100

- **Unsuccessful Applicants** - the average project size was higher than for the successful applicants, at 76 units and units were on average larger (925 square feet) with average rents of about \$910 per month. The average total cost per proposed unit was \$129,500. Again, the average project was not very attractive without the subsidy - it would generate negative net income of \$4,700 in the initial year.

The net operating income estimates (i.e., before mortgage payment) for these projects were estimated by the consultants since information on projected operating costs was not available - these were estimated conservatively at 25 percent of gross income.

For some developers, these pro formas may overstate the actual net income losses they would face on these projects. To the extent that developers had held land for some time but provided land costs which were reflective of current market values, their actual outlays would be less - though not necessarily their opportunity costs. Nevertheless, the information appears to confirm that on average the lack of short-run returns make new rental construction unattractive without some form of subsidy. Even given the prospect for longer-term capital appreciation, the degree of the initial shortfalls in net income would be unmanageable for most investors.

The distribution of the BCRSP projects by area within Vancouver is presented in Exhibit 6-13. Central areas (the City of Vancouver, New Westminster and Burnaby) accounted for just over half of all the units sampled (including both approved and not approved projects). Most of the remainder were in Surrey.

The above analysis provides an indication of the expected project performance for the average project, but not all projects reflect this average. Successful applicants were split about one-third (36 percent) for those who could be expected to generate positive net income in the first year of the project (i.e. income exceeds all expenses) and two-thirds (64 percent) for those with projects expected to generate negative net income. Without the subsidy, only one project approved under the Program could be expected to generate positive net income in the first year of the project - this project had very low land costs (about \$15,000 per unit).

Three pro-formas were constructed for typical projects of different types in the Vancouver area, based on information from the B.C. Rental Supply Program files, as well as other sources. Three hypothetical projects were constructed under two scenarios: mortgage rates in late 1990 (13 percent) and the 8 percent mortgage rate generally available under the Rental Supply Program.

- **Project V-1** - this project is a non-luxury townhouse project of 50 units. It is wood-frame in a suburban location. Average unit size is 1,100 square feet with initial monthly rent of \$1,045 per unit. This project would be able to generate positive net income in the first year even without the subsidy, although it would not be substantial. Part of the reason for the positive net income is the price of the land component (\$20,000), which is considered to be on the low side for a townhouse development (many developers contributed land at below market value for the BC Rental Supply Program).

EXHIBIT 6-14

EXAMPLES OF RENTAL INVESTMENT PRO FORMAS, VANCOUVER

	V-1	V-2	V-3
Project Type	Townhouse Wood-Frame	Low-Rise Wood-Frame	High-Rise Concrete
Unit Size (Sq. Ft.)	1,100	700	650
<u>Project Cost</u>		(\$ per unit)	
Land	20,000	26,000	35,000
Construction and Soft Costs and Profit	78,600	64,500	85,200
Total Project Cost	98,600	90,500	120,200
<u>Project Financing:</u>			
Total Project Cost	98,600	90,500	120,200
Mortgage	64,100	58,800	78,200
Equity	34,500	31,700	42,000
<u>First Year Revenues and Costs</u>			
Revenues			
Gross Income	12,300	8,600	9,200
Operating Costs	3,100	2,500	2,000
Net Operating Income	9,200	6,100	7,200
Mortgage Payments:			
At 8 percent	5,880	5,395	7,170
At 13 percent	8,480	7,780	10,345
Net Income:			
At 8 percent	3,320	705	30
At 13 percent	720	(1,680)	(3,145)
<u>Net Income in Subsequent Years:</u>			
Second	3,780	1,010	390
Third	4,275	1,330	780
Fourth	4,770	1,675	1,165
Fifth	5,315	2,030	1,590
Sixth*	3,260	5	(1,155)

* Subsidy expires.

Source: CitySpace Consulting and Clayton Research Associates.

- Project V-2 - this project is a low-rise (3¼ storey) wood-frame apartment building of 50 units located in the "inner suburbs". The average unit size is 700 square feet with initial monthly rent of \$735. This project would generate negative net income in the first year of \$1,680 per unit without the subsidy. With the subsidy, net income becomes slightly positive.
- Project V-3 - this is a high-rise apartment building of 85 units located in the inner city area. The average unit size is 650 square feet with initial monthly rent of \$750. Again, this project would return a substantial negative net income in the first year (of \$3,145 per unit) without the subsidy; even with the subsidy, the project barely breaks even.

The analysis shows that although some townhouse projects could cover their costs (albeit on below market value land), the economics of apartment projects were very unattractive without some form of subsidy. Even with the 8 percent interest loan subsidy, net income was not substantially positive for these projects. Also, of course, this analysis does not assess the relative returns available from developing a condominium rather than a rental property at that time (see Section 6.4.10.3).

There is also the issue of what happens after the expiry of the 8 percent interest loan subsidy (i.e. in 5 years). Would the project have reached the stage where it was in a positive net income situation without the subsidy? Assuming 5 percent annual increases in revenues and operating costs and 13 percent mortgage interest rates at the end of the five year period, the economics of some types of projects still appeared questionable at that time (at 11 percent mortgage rates the economics would, of course, improve).

Obviously, since it could have generated positive net income in year one even without the subsidy, the townhouse project (V-1) would be expected to be in a positive net income position after 5 years.⁶⁷ Project V-2, however, would just break even and Project V-3 would be generating substantial negative net income. The conclusion is that, in general, the economics of conventional rental housing were not attractive to developers in 1990 without some form of subsidy - and, even with a substantial subsidy for five years, may still not have been attractive.

The factors which are responsible for creating the situation which has led to unattractive returns on investment in new conventional rental housing are examined in Section 6.3.

6.2.4 Increased Costs - A Major Factor Behind the Poor Economics of New Conventional Rental Investment

There are no data available on the trends in land and construction costs for rental projects in Vancouver, however, it is clear that costs have escalated significantly in recent years. The primary reason for the increased costs has been the strong upturn

67 This assumes that mortgage rates are still 13 percent at the end of the initial five year period.

**EXHIBIT 6-16
CONDOMINIUM STARTS
VANCOUVER**

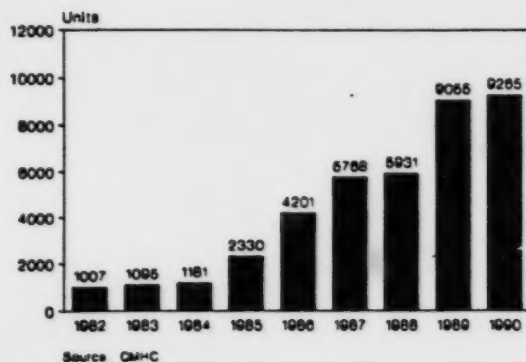


**EXHIBIT 6-16
AVERAGE MLS CONDOMINIUM PRICES**

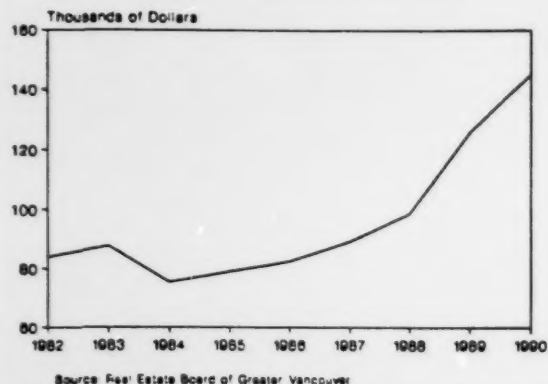


**EXHIBIT 6-17
SAMPLE OF SALES OF MULTIPLE BUILDINGS, VANCOUVER**

Subarea	Design	Number of Units	Average Price Per Unit		Selling as % of Asking Price	Net Operating Income Per Unit	Capitalization Rate*	% Equity Required for Zero Cash Flow at Following Mortgage Rates	
			Asking	Selling				11.5	13
Cambie	Low-rise	23	93,478	83,696	90	5,641	6.7	44	49
Downtown	High-rise	66	85,227	80,788	95	4,220	5.2	56	61
Fairview	High-rise	34	107,353	107,353	100	5,832	5.4	55	59
Fairview	Low-rise	56	88,393	83,036	94	5,845	7.0	41	47
Fairview	Low-rise	11	98,182	86,364	88	5,186	6.0	50	55
False Creek	Low-rise	16	54,688	51,063	93	4,837	9.5	21	28
Kerrisdale	Low-rise	9	108,889	107,556	99	5,256	4.9	59	63
Kitsilano	Low-rise	39	83,333	77,436	93	5,587	7.2	40	45
Kitsilano	Low-rise	12	116,667	108,333	93	6,833	6.3	47	52
Kitsilano	Low-rise	10	119,900	120,000	100	7,510	6.3	48	53
Kitsilano	Low-rise	13	91,923	86,154	94	5,652	6.6	45	50
Marpole	Low-rise	29	56,724	56,724	100	4,882	8.6	28	35
West End	Low-rise	29	34,483	29,966	87	2,456	8.2	32	38
West End	Low-rise	24	77,083	76,667	99	5,240	6.8	43	48
West End	Low-rise	26	73,077	69,231	95	2,927	4.2	65	68

Average Price Per Unit: \$78,300
Average Cap Rate Per Building: 6.6%

*Net operating income as a percent of selling price.

Source: CitySpace Consulting and Clayton Research Associates based on information from the Multiple Listing Service.

in demand for condominium dwellings - itself partly motivated by rental investments by small investors purchasing condominium units.

Condominium starts in Vancouver averaged over 6,800 units annually in the 1986-1990 period compared to only 1,400 per year in 1982-1985. In both 1989 and 1990, they totalled over 9,000 units. This dramatic increase in condominium activity put severe pressure on the limited supply of multiple land in the Vancouver area and, as a result, land prices have increased significantly. As an indicator of the scale of the increases in prices, the MLS average condominium price escalated from an average of \$82,500 in 1986 to almost \$100,000 in 1988. Prices escalated further to an average of \$145,000 for 1990.

There is little doubt that the dramatic increase in the volume of condominium activity had a crowding out effect on investment in the rental market. As the rental market recovered from the period of high vacancies and low rent increases in the mid 1980s, the economics of rental investment were constantly playing catch-up behind the ever-escalating costs of developing new multiple housing projects and the attractive returns available to developers in condominium projects. The costs of both construction and land were buoyed by the seemingly endless increases in demand for condominium units. The higher costs help to explain the fact that there was still a significant gap between the rents achievable on a new rental project and the costs of carrying that project despite the fact that rents increased above the rate of inflation in recent years.

6.2.5 Investment in Existing Buildings Not Generally Generating Short-Run Returns Either

Although they do not add directly to the stock of rental housing, buyers of existing rental buildings are nevertheless investors in rental housing. An examination of sales of a sample of 15 existing multiple properties in Vancouver from the beginning of 1989 to September, 1990 (Exhibit 6-17) provides some insight into the relative attractiveness of new versus existing housing as an investment vehicle.

The average price of the units was \$78,300. The average capitalization rate (i.e. net operating income as a percent of selling price) was 6.6 percent; given the 9-11 percent capitalization rates exhibited in markets in other parts of Canada, it would appear that investors were paying a substantial premium for the buildings in relation to their income. No doubt, this is at least partially due to expectations of further appreciation in the value of the buildings.

In most of the projects, investors would either be putting up substantial equity or would have to finance significant negative cash flows from the projects. Depending on the rate of interest on the financing obtained for these projects, an average of 45-50 percent of the purchase price would need to be provided in equity if the projects were to break even (at 11.5 percent and 13 percent mortgage interest rates, respectively). From anecdotal evidence, it appears that a substantial proportion of these existing rental properties were being sold to offshore investors and that their

EXHIBIT 6-18

**SYNDICATION OF EXISTING PROJECT
VANCOUVER**

Project Type	Townhouse
Unit Size (Sq. Ft.)	1,200

\$ Per Unit

Project Cost	44,600
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Project Financing

Total Project Cost	44,600
Mortgage	35,940
Equity	8,660

Annual Revenues and Costs

	<u>Projected</u>	<u>Actual</u>
Gross Income	6,300	7,800
Operating Costs	2,280	2,280
Net Operating Income	4,020	5,520
Mortgage Payments	3,840	4,530
Net Income	180	990

Source: Clayton Research Associates

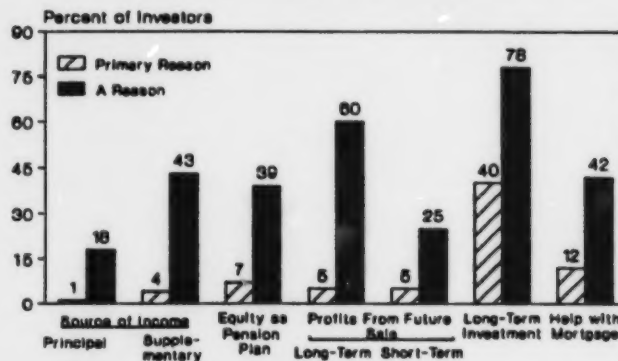
preference was to put up sufficient equity to ensure that the projects did not generate a negative cash flow.

A pro forma analysis of an existing rental project syndicated for sale to Canadian investors in 1988 provides an illustration of a successful investment in an existing rental project in Vancouver. This syndication was undertaken prior to much of the increase in prices which occurred in the Vancouver area. Highlights of the project (gained from the original prospectus plus discussions with an official knowledgeable about the project) include:

- Average price of \$44,600 per unit for a three-bedroom townhouse in a suburban location. The project was built in the early 1980s. This is less than half the estimated cost of a new townhouse project as presented in Exhibit 6-14.
- The project was originally financed with a 10.25 percent mortgage which was to be renewed in 1989. The prospectus assumed that the mortgage rate would continue at the same rate; however, rates averaged 12.25 percent in the period when the project was renewed so the investors would have faced much higher financing costs than expected.
- The higher financing costs were more than offset by higher revenues. The projected 1990 rents on the project were \$525 per unit per month; in fact, rents in this project were \$650 per month in 1990. This higher than expected revenue resulted in an increase in actual net income from the project in 1990 to an estimated \$990 per unit - well above the projected net income from the prospectus of only \$180.
- The investors in this case did very well. For an initial investment of \$8,660, an investor would have received roughly \$1,800 in tax write-offs in the first year for the various soft costs associated with the syndication. After that, no further tax write-offs were available but CCA could be used to offset the net income from the project so all of the net income would be received tax free in the hands of the investor. So, for an out-of-pocket investment of roughly \$7,000 in 1988, the investors received a return of roughly 14 percent in 1990 plus there would have been substantial capital appreciation on this project. At the 6.6 percent average capitalization rate for existing rental buildings sold in Vancouver in 1989-1990, the project would be worth roughly \$84,000 per unit.

There has been substantial turnover in the existing rental stock in Vancouver in recent years. It appears from the performance of the projects and the capitalization rates which investors are paying for rental properties that they are expecting further increases in rents which can justify the prices for which existing units are selling.

EXHIBIT 6-19
MAJOR REASONS FOR INVESTING
IN RENTAL PROPERTY, VANCOUVER



* Investors in non-conventional units.
 Source: "Survey of Rental Investors, Vancouver".

EXHIBIT 6-20

AVERAGE PROJECT PERFORMANCE
SURVEY OF NON-CONVENTIONAL RENTAL
INVESTORS, VANCOUVER

	House	Condominium
Sample Size* (Number of Respondents)	78	18
<u>Purchase Price and Finances</u>		
Purchase Price	166,200	105,200
Mortgage	107,000	66,900
Equity	59,200	38,300
<u>Current Annual Revenues and Costs</u>		
Gross Income	14,500	10,800
Operating Costs**	3,800	2,150
Net Operating Income	10,700	8,650
Mortgage Payments	15,600	9,000
Net Income	(4,900)	(350)

* Includes only those investors who provided complete financial information (about one-quarter of all respondents).

** Includes property tax, insurance and maintenance costs; for condominium, also includes condominium fees.

Source: Clayton Research Associates based on "Survey of Rental Investors, Vancouver".

6.2.6 Investors in Non-Conventional Housing Also Primarily Motivated by Prospects of Longer-Run Returns

Investors in non-conventional housing who were surveyed in 1990 as part of this study had a variety of reasons for investing in rental property. Long-term investment and profits from long-term sale were the most common reasons, followed by source of supplementary income, help with mortgage payments (mainly for secondary suites) or building equity as a pension plan. Although the above were all reasons to some degree, the **primary** reason for purchasing a rental property was as a long-term investment - 40 percent of respondents indicated this was their primary motive. Rising property values in recent years would have reinforced this perception of future capital gains.

A large proportion (12 percent) also indicated that they were renting the unit primarily to help with mortgage payments - this was mainly among suppliers of secondary suites, who might not have been able to afford to buy in the high-cost Vancouver market without the additional income.⁶⁸ Investors in secondary suites comprised 30 percent of the sample for the survey and were more likely to have this type of short-term goal than other investors - investors in houses and condominiums comprised 55 percent and 16 percent, respectively, of total survey respondents.

Financial information from the survey confirms that short-term goals are not a prime motivating factor for most non-conventional rental investors. The survey results were disaggregated to produce separate information for the following types of rental investments:

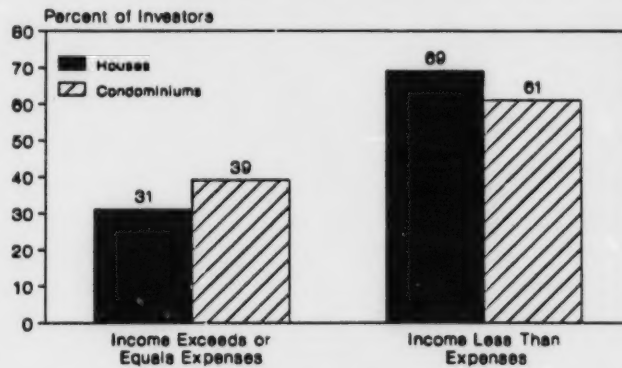
- **Single-detached house** - the average purchase price of houses being rented in the survey was just over \$166,000, with average rental income per month of about \$1,200.
- **Condominium unit** - the average condominium being rented in the survey was purchased for about \$105,000; average rental income was \$900 a month; the majority are townhouse units.

Exhibit 6-20 presents the 1990 financial performance of these two different investor groups. Net income per unit was substantially negative for the average investor renting out single-detached units (a net loss of almost \$8,000 per year). The average investor renting out a condominium also had a net loss, but much lower at \$350 per unit.

This analysis provides some insight into the average performances, but not all investors were doing poorly. About one-third of investors in single-detached houses indicated that income from the unit exceeded expenses for it, while about 4 out of 10 investors renting out condominiums were generating positive net income from the

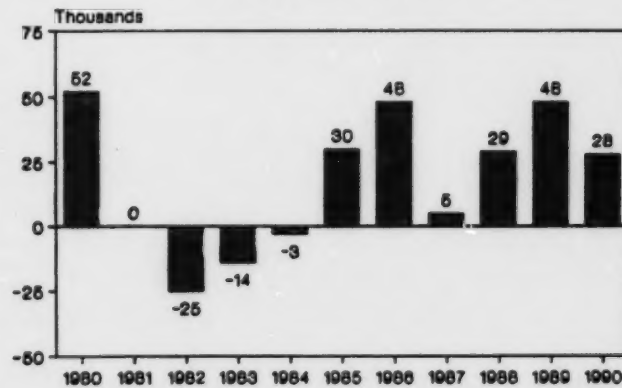
68 A large proportion of investors indicated that the primary reason was "to live in" the unit, either initially (a minority) or, more often, at some point in the future.

**EXHIBIT 6-21
COMPARISON OF INCOME
AND EXPENSES, VANCOUVER**



Source: "Survey of Rental Investors, Vancouver".

**EXHIBIT 6-22
EMPLOYMENT GROWTH
VANCOUVER, 1980-1990**



Source: Statistics Canada

unit. Also, this analysis does not take account of (the non-taxable) capital gains on the dwellings since their purchase.

The difficulty in separating mortgage payments and operating costs between investor-occupied and renter-occupied space makes an analysis of the financial performance of secondary suites more difficult. However, it appears that these suites in general are making a substantial contribution to covering some of owners' housing costs:

- Average rental income from secondary suites was \$675 per month. This compares to total mortgage payments and operating costs (for both the investor-occupied and renter-occupied space) of about \$1,435 on average per month.
- On average, therefore, rental income equals just under one-half of total costs related to the house. As the average secondary suite would not comprise one-half of the total space in the house, the average unit would appear to be generating substantial positive net income for the investor.

Most owners of secondary suites did not actually create the unit themselves (about three-quarters). For those who did create the unit:

- Average conversion costs were only \$9,400 - if this were **totally** financed by a mortgage (which in most cases did not occur) the monthly payment would be \$104 (at 13 percent over 25 years), well below the average monthly income of \$675.
- On average, two-thirds of the conversion costs were paid for out of savings - that left only \$3,100 of the work on average to be financed.

6.3 DEMAND FACTORS INFLUENCING RENTAL INVESTMENT IN RECENT YEARS

The underlying requirements for rental housing have been strong in Vancouver over the past few years, although affordability problems have acted to constrain actual demand.

6.3.1 The Economic Upturn Increased the Underlying Requirements for Rental Housing

The Vancouver area economy experienced a marked turnaround in 1985 following several years of actual losses to its employment base. The recovery in the U.S. housing market and the construction of Expo 86 contributed to the recovery. The economy remained buoyant in 1987, although there was a pause in job creation. Employment growth surged in 1988 and again in 1989. Job creation slowed in 1990, but remained at a fairly strong level.

EXHIBIT 6-23

NET MIGRATION BY COMPONENT
VANCOUVER, 1981-1989

	Net International	Net Interprovincial	Net Intraprovincial	Total Net Migration
1981-1982	11,499	3,375	(5,398)	9,476
1982-1983	6,881	1,640	1,732	10,253
1983-1984	6,377	5,685	5,183	17,245
1984-1985	4,735	1,937	5,786	12,458
1985-1986	5,142	1,685	7,663	14,490
1986-1987	7,204	4,376	5,164	16,744
1987-1988	12,513	9,381	3,059	24,953
1988-1989	16,927	13,361	(385)	29,903

Source: Statistics Canada

EXHIBIT 6-24

MIGRANT HOUSEHOLDS BY
MOBILITY STATUS AND TENURE
VANCOUVER

Migrant Households to Greater Vancouver Area 1981-1986	Tenure in 1986		Total*
	Owners	Renters	
From Other Countries	40	60	100
From Other Provinces	32	67	100
From Other Parts of B.C.	34	66	100
All Households Living in Greater Vancouver Area in 1986	56	44	100

* Totals may not add due to rounding.

Source: Gregory M. Schwann, "When Did You Move to Vancouver?", The Laurier Institute, 1989.

This resurgence in economic fortunes enhanced consumer confidence in the Vancouver area and encouraged household formation. It also attracted the attention of job seekers from other parts of B.C. and Canada as well as migrants from abroad. Net migration is estimated to have reached about 30,000 persons in the 12 months ending June, 1989, compared to about 12,500 in the first half of the 1980s.

The increase in net migration to Vancouver had a particularly strong impact on the requirements for rental housing. Data from the 1986 Census show that, depending on where they moved from, 60 percent or more of the households moving to the Vancouver area in the 1981-1986 period rented their accommodation, significantly above the 44 percent of all households in Vancouver who were renters in 1986.

In summary, the strong economy stimulated overall rental demand, both from existing population and from in-migrants, which contributed to lower vacancy rates and consequently higher rent increases. Other things being equal, these higher rents should have resulted in some relative improvement in the cash flow and expectation of capital appreciation from rental investment.

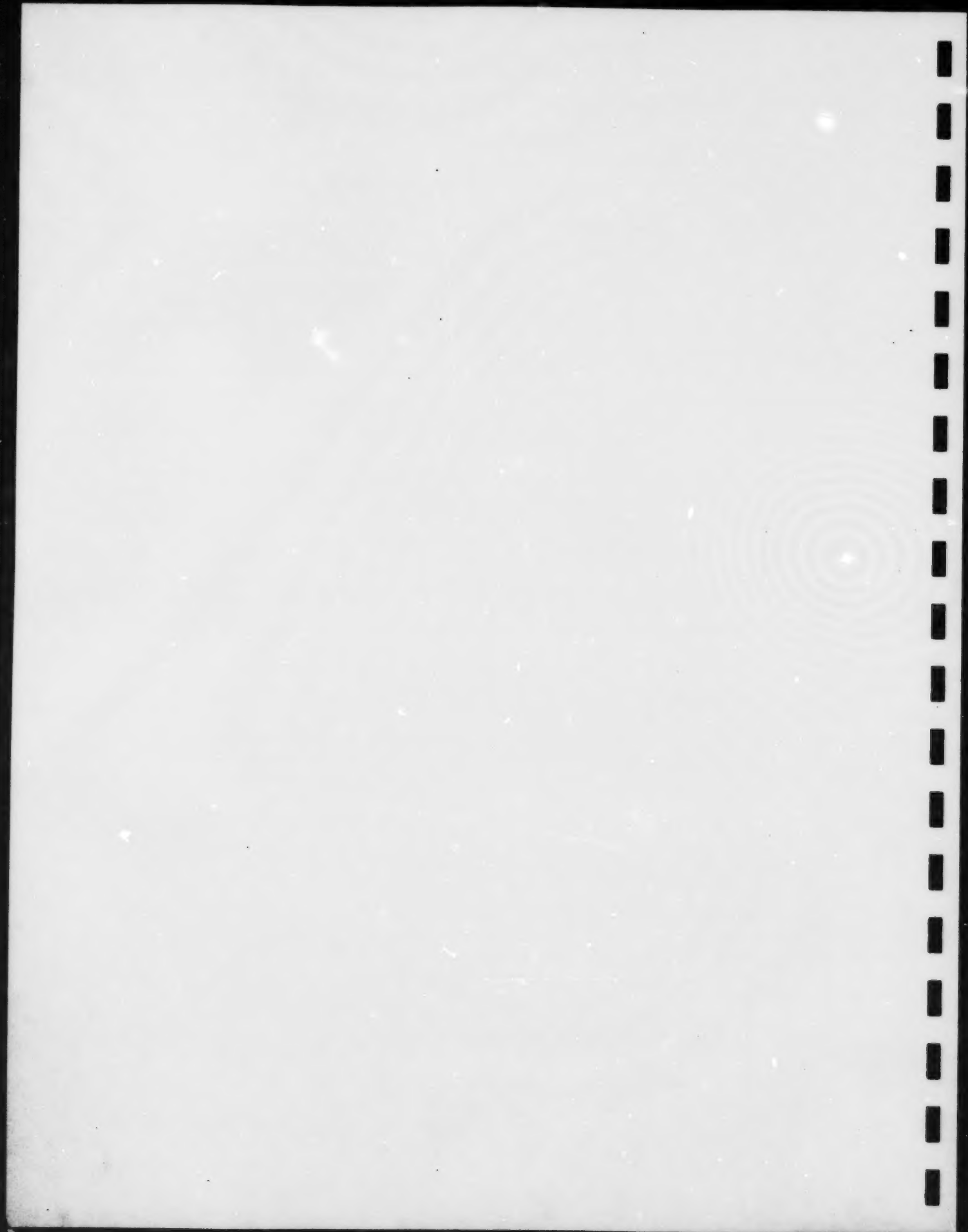
6.3.2 But Renter Affordability Problems Constrain Rents

Even without the alternative sources of cheaper supply such as secondary suites, it is unlikely that rents would have risen sufficiently to support the higher costs of new construction described earlier in this chapter. Instead, it seems likely that renters with affordability problems would have increasingly doubled up within the existing stock.

Estimates by the B.C. Housing Management Commission indicate that about 78,000 renters (or one-third of all renter households) in the Vancouver area would have had to pay more than 30 percent or more of income to secure adequate accommodation in 1986. It is unlikely that the number of renters with an affordability problem has improved since 1986; in fact, the opposite has probably occurred, given that average rents appear to have outpaced average renter income growth.

The groups with the most serious affordability problems include low-income lone-parent families, low-income single people, especially those with psychiatric or physical disabilities, and fixed-income single people over the age of 65.

Thus, although the improved economy translated into higher requirements for rental housing, affordability problems for many renters translated into resistance to rising rents, constraining effective demand and, consequently, rent increases, below the levels necessary to induce new conventional construction.



6.3.3 And, The Availability of Alternative Sources of Supply Helped to Constrain Rent Increases Below Those Necessary to Support New Construction

As indicated earlier, the economics of new conventional rental housing were not favourable in Vancouver in the late 1980s and 1990; for supply to be forthcoming, demand would have had to have been significantly higher and rents would have had to have risen substantially more than they did.⁶⁹ Although demand pressures did cause an increase in rents, the increased availability of alternate sources of lower rent supply (i.e., secondary suites), kept rents in the overall stock suppressed to some degree - below the level necessary to induce new construction.

To compare, the average rent indicated by the survey of rental investors for secondary suites (of all sizes) was below \$700 a month. Rents for standard 1 bedroom units subsidized under the British Columbia Rental Supply Program were in the \$600-\$750 range; for 2 bedroom units, the rents were \$700-\$1,000. Obviously, economic rents for unsubsidized units would have to be substantially higher to obtain a reasonable rate of return, making them non-competitive with secondary suites.

6.3.4 Also, Many Upper-Income Renters Purchased a Home or Moved to Rental Condominiums and Houses

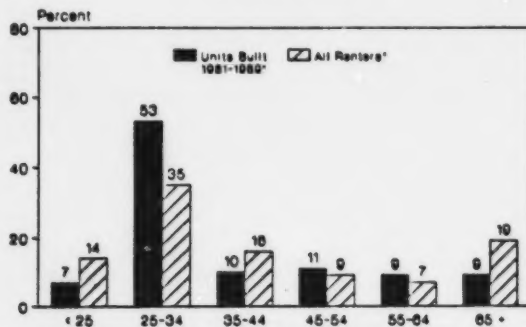
The dramatic increase in condominium construction in the late 1980s (see Exhibit 6-15) would have provided direct competition to any new large luxury rental projects since the condominium product was directed largely at higher-income renters. To the extent that these higher-income renters left the rental market for the homeownership market, requirements for total rental accommodation were reduced (putting less pressure on rents than might have occurred) and leaving the remaining potential renter population relatively poorer.

Also, for those higher-income renters that remained in the rental market, the option of rental condominiums and houses would have been an attractive alternative to conventional rental housing. While data are not available to confirm this observation, anecdotal information suggests that many higher-income renters, who would have been able to afford the higher rents associated with new conventional rental units, were able to find alternative high-quality accommodation in the increasing supply of houses and condominiums on the rental market.

Together, affordability problems among much of the renter population, alternative low-cost supply in the form of secondary suites and loss of potential high-income renters through occupancy of rental condominiums and houses or purchases of condominiums, eroded much of the potential demand for conventional new rental housing. This erosion of potential demand prevented rents from rising more rapidly

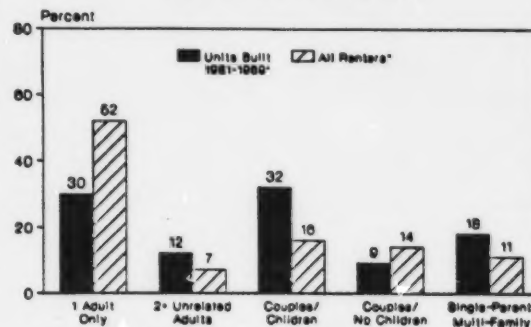
69 Recall the "limbo" of the kinked supply curve presented in Chapter 2, where rents rise, but not enough to induce conventional supply increases.

**EXHIBIT 6-25
RENTER HOUSEHOLDS BY
AGE OF HEAD**



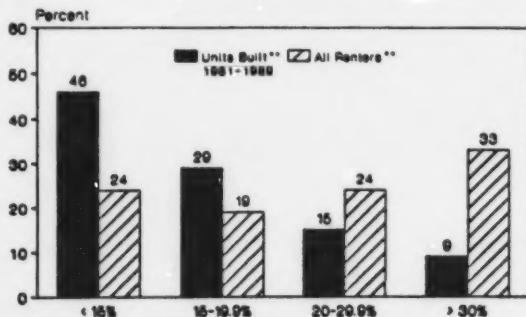
* British Columbia centres of 100,000 plus population.
Source: 1989 HIFE data files

**EXHIBIT 6-26
RENTER HOUSEHOLDS BY
HOUSEHOLD COMPOSITION**



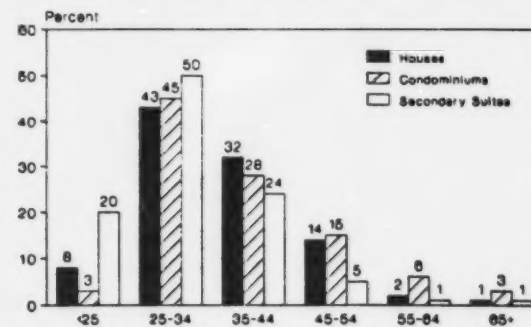
* British Columbia centres of 100,000 plus population.
Source: 1989 HIFE data files

**EXHIBIT 6-27
RENT/INCOME RATIOS***



* Annualized April, 1989 rent over 1988 household income.
** Data are for B.C. Centres of 100,000 plus population.
Source: 1989 HIFE data files

**EXHIBIT 6-28
RENTER HOUSEHOLDS IN NON-CONVENTIONAL
UNITS BY AGE OF HEAD, VANCOUVER**



Source: "Survey of Rental Investors, Vancouver"

towards the levels necessary to be attractive for the development of new conventional rental housing.

6.3.5 Younger, Larger Households in Newer Rental Accommodation

Little information is available on the occupants of rental units constructed in Vancouver in recent years. However, some information exists for centres of 100,000 or more on occupants of rental units built in the 1981-1989 period.⁷⁰ As Victoria is the only other centre of 100,000 or more population in B.C., the results are considered to be highly representative of the Vancouver situation. The information indicates that the occupants of units built in the 1981-1989 period were:

- **More likely to be younger** - 60 percent of the occupants of newly built units were less than 35 years of age compared to about half of renters as a whole. As well, less than 10 percent of the households in new buildings were 65 or older, compared to almost 20 percent of all renters.
- **Less likely to be one-person households** - just over 50 percent of all renter households were one-person; in units constructed in 1981-1989, the comparable proportion was 30 percent. Families with children, including single-parent families, accounted for a large proportion of the households living in the newer stock (half versus 27 percent for all renter households) - one of the reasons for this is likely the large proportion of publicly supported new rental units.
- **Less likely to have affordability problems** - less than 10 percent of occupants of units built in 1981-1989 paid more than 30 percent of income in rent, compared to about one-third of all renters.⁷¹ This appears to confirm that the filtering process is working in Vancouver; higher-income renters appear to be choosing the higher-rent new stock and leaving the less costly older stock to lower-income tenants - though many of these cannot afford even the lower-rent stock.

The survey of rental investors also provides some insights into the characteristics of renters in non-conventional units, in terms of age of head, household type and location of previous residence:⁷²

- **Occupants of secondary suites generally younger** - 70 percent of secondary suites were occupied by households headed by someone less than 35 years of age (about half of renter households in general fall into these age groups). A higher proportion of both houses and condominiums were occupied by households in the 35-54 age groups. Very few households in any

70 Based on Statistics Canada's 1989 HIFE microdata file.

71 These are cash rent to income ratios.

72 The information was provided by the owner, not the tenants themselves.

EXHIBIT 6-29
RENTER HOUSEHOLDS IN NON-CONVENTIONAL
UNITS BY HOUSEHOLD TYPE, VANCOUVER

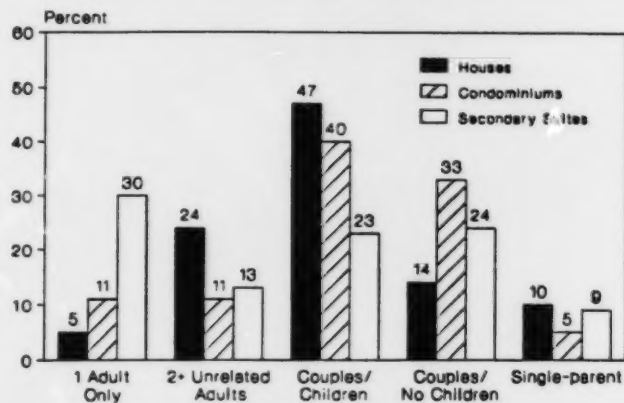
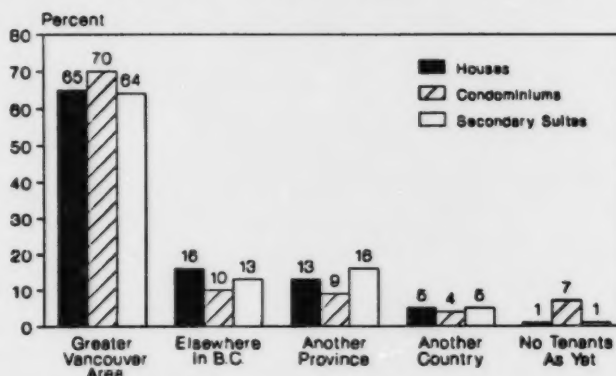


EXHIBIT 6-30
RENTER HOUSEHOLDS IN NON-CONVENTIONAL
UNITS BY PREVIOUS RESIDENCE, VANCOUVER



of the non-conventional dwelling types had heads aged 65 years or older - they appear to prefer conventional rental accommodation.

- **Single-person households more common in secondary suites** - 30 percent of secondary suites were occupied by a single person; a further 37 percent were occupied by couples or 2 or more unrelated persons. Both houses and condominiums were more likely to be occupied by couples with or without children; over 60 and 70 percent of houses and condominiums, respectively, were occupied by couples with or without children - this is more than double their share of the total renter population.
- **Majority of tenants from Vancouver area** - about two-thirds of renter households in each type of non-conventional unit lived in the Vancouver area previously. A substantial proportion, however, were from other provinces and other countries (about 1 in 5 households in total); the remainder were from elsewhere in B.C.

In general, non-conventional supply, which has been an increasingly important part of the Vancouver rental market in the last several years, appears to have provided housing appropriate to the needs of its occupants. Smaller and younger renter households are tending to rent secondary suites whereas families, particularly those with children, are choosing larger accommodation - rental houses and condominiums. As noted earlier (Section 6.2.6), these non-conventional units also provide a range of rental rates from inexpensive secondary suites to expensive houses and condominiums.

6.4. REVIEW OF POTENTIAL FACTORS INFLUENCING ATTRACTIVENESS OF RENTAL INVESTMENT IN VANCOUVER

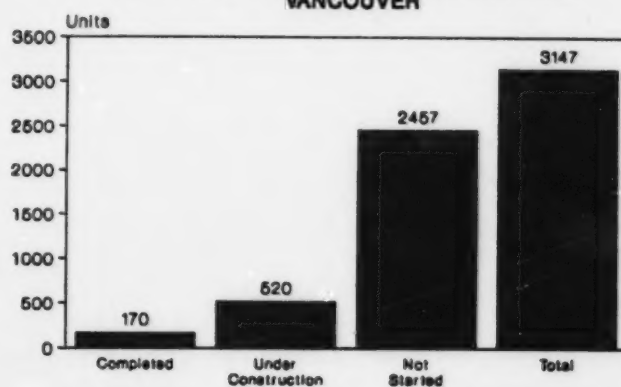
This section presents a review of the importance of each of the major factors influencing the attractiveness of rental investment (identified in Chapter 2 of this study) in terms of their influence on the Vancouver rental market in recent years.

6.4.1 B.C. Rental Supply Program Improves the Attractiveness of Rental Investment But Has Not Impacted Starts to Date

There has been only one program to stimulate private rental supply in recent years: the British Columbia Rental Supply Program (BCRSP) introduced in the 1988 Provincial Budget. The program offers developers of new private rental accommodation a subsidy for the initial five years of the project which equals an amount up to the differential between actual financing costs at current mortgage rates and what they would be at an 8 percent mortgage rate.

The response by developers to this program indicates that there is clearly still interest in building new private rental housing - approximately 100 applications were

**EXHIBIT 6-31
BRITISH COLUMBIA RENTAL SUPPLY PROGRAM
UNITS APPROVED AS OF NOVEMBER, 1990
VANCOUVER**



Source: CitySpace Consulting and Clayton Research Associates based on information from the British Columbia Rental Supply Program.

received in the Vancouver area (for a total of over 6,500 units). About 3,100 units had received approval as of November, 1990, however, less than 700 units had been started, so the impact of the program on the market thus far has been insignificant.

Exhibit 6-12 in Section 6.2.3 illustrated the impact of the program subsidies on the economics of rental investment in 1990. The analysis indicated that even after 5 years, net income on the projects would be minimal, assuming 13 percent mortgage rates continued. It is likely, however, that program participants subscribed to the general view that mortgage rates over the longer-term would be below this level and the recent drop in interest rates confirms this view. The longer-term economics of these projects are significantly improved at 11 percent interest rates.

Moreover, to the extent that developers are strata-titling these projects, some may be intending to transfer the units to the condominium market at the end of the subsidy period. Over 75 percent of program applicants indicated that the units were to be strata-titled.

In summary, there has been substantial response to the Rental Supply Program in the Vancouver area; for many projects, it improved the short-run net income picture enough to attract developers with hopes of more substantial longer-term gains. In total, the 3,100 units approved under the program were equivalent to all of the private conventional rental construction in Vancouver in the 1985-1989 period. However, it is relatively small compared to the 5,700 units which have been added to the rental stock annually through non-conventional sources of supply over the 1985-1989 period.

6.4.2 Levels of Government Supply Remained Low

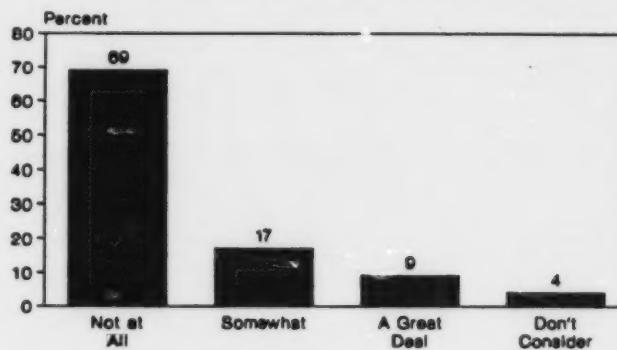
In recent years the bulk of newly-built conventional rental housing has consisted of publicly-initiated housing. However, the number of publicly-initiated rental starts has been steady at roughly 1,400 units annually in recent years because of limited growth in CMHC's budgetary allotments for the non-profit and cooperative housing programs.

While publicly-initiated rental activity has remained relatively low throughout the second half of the 1980s, it has been much more substantial factor in Vancouver than in any of the other markets examined in this study. Nonetheless, while these public units have clearly added to the demand for land and construction labour and materials, they are not considered to have been a significant factor in the escalation in the costs of multiple unit buildings in recent years.

6.4.3 Interest Rates a Significant Factor

The decline in mortgage interest rates in 1987-1988 (to the 11.5 percent range) improved the economics of new rental investment. However, the decline was not enough to substantially improve the financial performance of most projects (i.e. to the

EXHIBIT 8-32
CONCERNED ABOUT REINTRODUCTION
OF RENT CONTROLS, VANCOUVER*



* Investors in non-conventional units.
Source: "Survey of Rental Investors, Vancouver".

stage where the investment would actually occur), given the higher costs and only moderate increases in real rents.

Rents began to rise more rapidly in 1989 and 1990, but by then mortgage rates were on the rise again. The increase in mortgage rates to the 13 percent range in 1990 further detracted from the attractiveness of rental investment; at the 13 percent rate, the pro forma analysis in Exhibit 6-14 confirms that most projects were not economically attractive. At 11 percent, the economics of rental investment improves, however, most projects would still have substantial negative cash flows in the early years after completion.

6.4.4 Tax Policies Provide Little Encouragement For Conventional Rental Investment

Tax-driven investments have not been a significant factor in the Vancouver rental market in recent years. While syndications of existing buildings have occurred, there has been little or no syndication activity in new rental construction. The tightening up of the tax shelter rules in the early 1980s was likely a factor in the slowdown of new rental construction in Vancouver, but it is unclear why syndications which were so popular in some markets in other parts of Canada were generally not a factor on the west coast even after the market tightened after 1987. A major reason is likely the high cost structure of the market. Another likely reason is the volatile history of the Vancouver rental market compared to most other centres and a reluctance of investors to invest in rental housing there.

The increase in the non-conventional supply of housing in Vancouver is, however, likely related to some extent to the change in the capital gains tax rules in the mid 1980s. The exemption of the first \$100,000 in capital gains from taxes was likely a powerful incentive for many of the individuals who, perceiving an upturn in the general housing market (particularly the condominium market), invested in a house or condominium as a rental property.

6.4.5 Some Fear of Reintroduction of Rent Controls But Not Considered a Major Factor

B.C. introduced rent controls in 1974, a year prior to the general imposition of rent controls as part of the federal anti-inflation program. Rent controls in B.C. were phased out beginning in 1978 and the province has not had any form of rent control since 1983. All other things being equal, this would have been expected to have had a positive impact on the environment for rental investment since that time and ultimately result in increased production.

As noted earlier, however, rents remained constrained through the mid 1980s as a result of the weak rental demand that accompanied the weak economy. When rents did begin to rise in the late 1980s, the possibility that rent control might be re-introduced became a worry for some potential investors, but discussion with industry

participants indicates that this feeling was not widespread. Most larger building owners have covered themselves by strata-titling the projects to protect their investment by giving them the option of converting the projects to condominium occupancy at a future date, if rent controls are reintroduced.

The issue seems to be of somewhat more concern to investors in non-conventional rental housing. The survey of non-conventional owners indicated that most investors thought about the issue before investing, and about 1 in 10 was greatly concerned by it; a further 17 percent were somewhat concerned. One-third felt that the reintroduction of rent controls would make selling the property more difficult. Despite their concerns, however, a large number of investors clearly went ahead and purchased - it is clear from the large volume of non-conventional rental investment that has occurred that, although some potential investors may not have gone ahead because of this issue, many did.

In summary, rising rents may have generated fear among some potential suppliers of rental housing that the reintroduction of rent controls in the future would negatively impact future cash flow and therefore the value of rental property. Although this may have been a factor for some investors, the concern does not appear to be widespread and is not considered to be a major factor behind the lack of investment in conventional rental housing in recent years.

6.4.6 Landlord/Tenant Legislation In General Not a Significant Deterrent But New Bill May Have Some Negative Impact on Rental Investment

According to observers, the Residential Tenancy Act until recently had little regulatory content or tone which would have lessened the attractiveness of rental investment. The Act mainly served to identify the rights and responsibilities of each party and to provide information on the dispute resolution mechanisms that were available if needed.

In September, 1990, Bill 51 came into effect. This Bill limits the landlord's control regarding to whom he/she may deny accommodation. In particular, the intent is designed to limit the landlords' rights in refusing rental accommodation to families with children.

The legislation allows a few exceptions, in the cases of the following:

- Housing which has been designated for the use of tenants who are 55 years and over.
- Housing which has been designated for the use of disabled tenants.
- Rooms in a private residence rented out by the occupier of that residence.

This new regulation may be interpreted by some rental investors as undesirable but is unlikely to significantly affect the attractiveness of rental investment. Certainly, it was not a factor in the lack of conventional rental construction in the late 1980s.

6.4.7 Condominium Conversion Legislation Not a Major Deterrent

Most municipalities in Vancouver have policies that restrict the conversion of non-strata-titled rental units to condominium tenure. This, however, does not seem to be a major disincentive for new rental investment. Most large projects today register as condominium when built, thus avoiding any problems with converting to condominium tenure in the future.

To the extent that condominium conversion policies limit the potential for capital appreciation through future sale as condominiums, the existence of restrictive policies in Vancouver may reduce the attractiveness of investment in existing rental buildings. However, as most new buildings are strata-titled, this is not a major deterrent to new construction.

6.4.8 The Municipal Regulatory Environment Detrimental to New Construction

In Vancouver, development is governed by each municipality using a range of land use and planning controls vested in them through the authority provided by the **Municipal Act**. For example, in the City of Vancouver, the **Vancouver Charter** takes precedence. These controls include the Official Community Plan and Development Permit Area, zoning by-laws, licensing and permits, and subdivisions/strata-title approvals. Decisions made at this level are final and, unlike some other jurisdictions, cannot be appealed to a higher planning authority.

The municipal regulatory environment in Vancouver municipalities can seriously impact the attractiveness of rental housing investment through the following types of regulations:

- Regulatory policies which have a clearly measurable financial impact. Key examples here are development cost charges and parking standards (which directly affect development costs) and municipal zoning practices (which increase both holding costs and the administrative costs of development).
- Regulatory policies which are designed to encourage or "oblige" rental construction in new developments through measures such as bonus zoning, mandatory inclusion and lot size/zoning categories to facilitate rentals.
- Regulatory policies which restrict supply options, such as regulations which restrict secondary suites or condominium conversions.

These regulations are discussed in more detail in the following sections.

EXHIBIT 6-33

DEVELOPMENT COST CHARGES: SELECTED MUNICIPALITIES, GVRD

<u>Municipality</u>	<u>Townhouses</u>	<u>Apartments</u>			
	<i>Dollars Per Unit by Multiple Housing Type/Density</i>				
Burnaby	\$829 (12 upa)	\$884 (20 upa)	\$1,397 (50 upa)	\$1,264 (80 upa)	\$1,436 (100 upa)
Richmond	\$11,176 (12 upa)	\$9,938 (20 upa)	\$5,892 (50+ upa)	-	-
North Vancouver City	0	0*			
Coquitlam	\$955	\$955			
Surrey	\$5,060-\$8,160	\$6,360			
Vancouver	0	0			

* All types.

Source: CitySpaces Consulting.

EXHIBIT 6-34

PARKING STANDARDS SELECTED MUNICIPALITIES, GVRD

<u>Municipality</u>	<u>Parking Required Per Unit*</u>	
	<u>Townhouses</u>	<u>Apartments</u>
Burnaby	1.75	1.60
Richmond	1.70	1.70
North Vancouver City	1.50	1.20
Coquitlam	1.45	2.00
Surrey	2.20	1.5 (1 bdrm), 1.75 (2 bdrm)

* Includes visitor parking

Source: CitySpaces Consulting

6.4.8.1 Development cost charges add to project cost

Development cost charges (DCCs) for multiples in the Vancouver area municipalities are generally on a per unit basis and are imposed to finance off-site costs, usually roads, services and parkland. They are authorized under the B.C. Municipal Act. There are significant variations in the levels of development cost charges across the municipalities in Vancouver. In general, however, mature, urbanized, centrally located municipalities have not had significant DCCs. For example, in the selection of municipalities examined in Exhibit 6-33, the charges for low-density apartments (20 units per acre) ranges from no charge in the City of Vancouver and North Vancouver to almost \$10,000 in Richmond.

The impact of DCCs can be illustrated by assuming 75 percent of the charges are debt financed. At a 13 percent interest rate, the monthly per unit impact would vary from nil in Vancouver and North Vancouver to \$90 per month in Richmond. This would substantially increase monthly expenses and correspondingly decrease cash flow on a rental project. For condominiums, DCCs would similarly add to the cost, and hence price, of a unit.

Discussion on introducing DCCs by municipalities which currently do not have them has been evolving in recent years. Concern exists in the mature municipalities regarding the cost implication of replacing infrastructure. Also, consideration has been given to using DCCs as a tool to raise money for social/affordable housing. In 1990, the City of Vancouver sought and obtained approval to amend its Charter to allow the introduction of DCCs for housing purposes.

While they have clearly added to the cost of building rental housing in some municipalities, it is unlikely that DCCs were a significant factor in the lack of new conventional rental construction in Vancouver in recent years.

6.4.8.2 Parking standards not generally a disincentive to rental investment

Parking standards can impact significantly on rental housing costs; this is less true for townhouses than for apartments, where design and density requirements often necessitate underground parking. A review of parking standards was undertaken for selected municipalities. The requirements varied widely for each. Standards varied by as much as a difference of 0.7 spaces per unit in the case of townhouses to 0.8 spaces per unit for apartments. For the most part, however, differences were relatively minor.

Discussions with the development industry suggest the current parking standards are not generally an issue in terms of deterring new rental investment. Among developers and for property managers, there is a shared concern over the problems created by inadequate parking and, therefore, the cost of parking is viewed as an acceptable or necessary development cost.

EXHIBIT 6-35

**MINIMUM APPROVALS TIME
SELECTED MUNICIPALITIES
VANCOUVER**

<u>Municipalities</u>	<u>Months</u>
Surrey	7
Burnaby	6
Richmond	6-8
Coquitlam	6
North Vancouver	3-5

Source: CitySpaces Consulting based on
discussions with municipal staff.

As parking standards are generally in line with what developers perceive to be necessary, they do not impose additional costs on projects and therefore do not detract from the attractiveness of rental investment.

6.4.8.3 Lack of pre-zoned land - a MAJOR issue

Probably the most significant feature of the municipal regulatory process in Vancouver is the **virtually complete absence of "pre-zoning" for land**. There is a near consensus amongst municipal politicians that large-scale pre-zoning is unacceptable though there are exceptions to this; for example, in the City of Vancouver there has been a policy of expanding housing opportunities by seeking to rezone relatively large tracts of land including former industrial sites. Pre-zoning of lands, including zoning for multiple housing, does not generally occur on a large scale in the peripheral areas of the metropolitan area. Pre-zoning of significant lands has usually occurred on special, well defined sites currently or previously owned by the government or one private corporation. Examples of these are the Federal Penitentiary site in New Westminster (now Fraserview), the Provincial Oakalla Prison, and Royal Quay on Lulu Island in New Westminster owned by MacMillan Bloedel and Bosa.

In practice, this lack of pre-zoning means that land in urbanizing municipalities almost always has to go through a rezoning process on an individual parcel basis, usually immediately prior to development. The supply system, therefore, closely parallels the "just in time" character of automobile assembly. Inventories of "spare parts" e.g. zoned land, are not maintained. Developers have to buy from land owners and take land through the approvals process on an individual parcel basis.

Although land is not generally pre-zoned, current practice among municipalities is to **predesignate** land for multi-family housing through community and neighbourhood plans. This provides **some** level of assurance that a rezoning for this use/density will be approved when a development application for rezoning comes forward, but is not in itself a **guarantee**. The rezoning process must still be undergone.

Approvals times have lengthened in recent years due to the unanticipated upswing in both single-family and multi-family demand in the late 1980s, which put strains on municipal resources. Average approvals time vary substantially from one municipality to another, but it appears that the **minimum** period required for a straightforward rezoning varied from 3-5 months up to 7-8 months in 1990. More complex mixed use or large site rezonings typically take up to nine months and, in some cases, have taken up to 2 years.

A series of seminars conducted by the consultants in 1990 as part of a separate study of affordable housing in the Greater Vancouver Regional District provided an opportunity to discuss the issue of pre-zoning with over 100 politicians and municipal representatives. The following key points resulted from this interchange:

- The major motivation against pre-zoning is the "loss of control". Municipal politicians consider rezoning immediately prior to development as the major means of exercising control over the appearance and type of development.
- Most politicians do not perceive a relationship between constrained land supply and increases in prices - this view was widely and strongly held.
- Those who do accept such a relationship between the approvals process, costs and ultimately supply, appear prepared to accept this as a reasonable cost of maintaining control over development.
- A portion of politicians of all political spectrums see zoning as a "gift of value" i.e. as giving land owners a windfall profit and encouraging speculation.
- There is a predisposition against multiple housing in most suburban communities; pre-zoning would take away the potential for elected representatives to respond to this opposition.
- There is a widespread belief that pre-zoning for multiples merely contributes to the supply of condominium land. Municipal representatives have formally requested that the Province permit zoning for rental-only tenure. The objective is to capture land at a lower market price for rental use.

Politicians' views are heavily influenced by the residents of their jurisdictions. There has been much community opposition to multiple projects and there appears to be an increasing anti-growth sentiment in Vancouver which has been fuelled by the concentration of development in certain areas (such as Surrey and the North Shore communities) and the loss of farmland.⁷³ Given the prevalence of these views, it does not appear likely that municipal pressure for any major changes to the system will come about in the near future.

The question is: how severely does the lack of pre-zoned land add to development costs and detract from the attractiveness of rental investment?

Developers maintain that the drawn-out and uncertain approvals process is a direct contributor to increased production costs for all types of new housing, including new rental housing. In discussions with developers, a common theme was that municipalities cannot be trusted. Several told of situations they had faced wherein they had projects ready to begin, but approvals were held up; others had proposals rejected despite the fact that they conformed with the predesignation. To the extent that these situations occur, it appears clear that drawn-out approvals and lack of certainty of approval would increase the risk and cost of development and act as a deterrent for at least some investors.

73 For example, the pro-development councils of Richmond and Delta were defeated in the recent civic elections, while Surrey's mayor was re-elected on a platform of controlling urban sprawl.

In addition to the incremental development costs and risks associated with the time and effort spent in the approvals process, it appears that inadequate supplies of pre-zoned land reduce the short term supply and result in higher land prices in times of high demand - such as recently in Vancouver.

The lack of pre-zoned land in times of high demand does not affect the cost of rental housing only. By creating shortages, it drives up the price of land generally. As such, it also impacts on the cost of condominiums. Why then were so many condominium developments built in Vancouver in the late 1980s but so few conventional rental projects? The answer is simple: the condominium returns were sufficiently high that developers were motivated to "hang in" and endure the process even though it was uncertain and added to costs - extra costs could (and were) passed on to buyers in the form of higher prices. The economics of rental development, as demonstrated in previous sections of this chapter, were not nearly as attractive. It was a simple risk-return judgment on the part of developers: condominium returns justified the risk, rental development returns did not.

A final point with respect to the approvals process, discussions with industry participants indicate that the complexity of the approvals process appears also to be more of a deterrent to smaller developers than large ones - this is likely due to the fact that the costs (in terms of risk of non-approval and administrative costs related to the application) would be higher on a per unit basis. Also, the risks for larger developers would be reduced to the extent they are spread over a larger number of projects.

6.4.8.4 Bonus zoning and mandatory inclusion not widespread

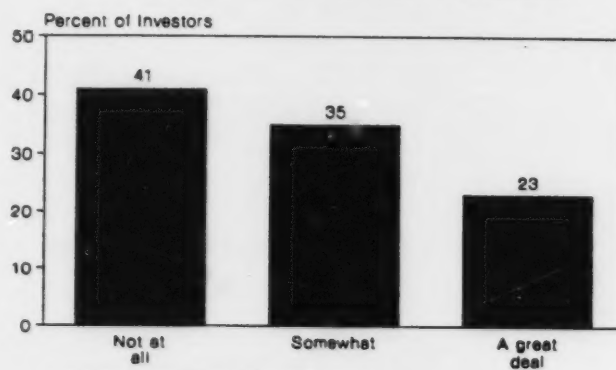
Municipal measures designed to encourage or oblige rental housing in new developments have been confined primarily to large scale projects in the City of Vancouver and Burnaby. These measures have mainly taken two forms:

- **Bonus zoning:** allowing a project a higher floor space ratio (FSR) than designated; and
- **Mandatory inclusion:** requiring a certain proportion of affordable housing in a project.

In the City of Vancouver, for example, the Coal Harbour project requires a 20 percent social housing component. Also included is a rental incentive bonus, which provides an additional 0.5 FSR ratio for the project - this would allow an extra 725 units. The attractiveness of the incentive is limited, however, by the municipality's requirement that additional parkland be provided as the density increases.

Other projects have been required to include a social housing component, but without receiving bonus zoning for market housing. The practice is not universal for large scale projects - several very large projects have recently received approvals with no requirement for social or affordable housing.

EXHIBIT 6-36
DEGREE TO WHICH RESTRICTIONS
ON SECONDARY SUITES CAUSED CONCERN*



* Investors in secondary suites only.
Source: "Survey of Rental Investors, Vancouver".

While bonus zoning in itself could be an incentive for rental housing, it is often used in conjunction with mandatory inclusion, thereby reducing its impact. Mandatory inclusion by itself would reduce the attractiveness of rental investment by reducing the number of market units available in a project with a given FSR and adding to development costs. In addition, the complication of dealing with the measures would increase administrative costs. However, these practices are not considered to have been sufficiently widespread to impact substantially the attractiveness of rental investment in Vancouver.

6.4.8.5 Municipal regulations restrict secondary suites

In most Vancouver municipalities, the creation and operation of secondary suites is restricted, although not strictly enforced. The proliferation of secondary suites, despite their illegality, has prompted many municipalities to review their current policies with regard to this housing form.

In the City of Vancouver, secondary suites of any type in RS-1 zones have been illegal for decades. In recent years, however, the City has distinguished between "family" suites (which accommodate members of the owner's family) and "revenue" suites; the former are now permitted on a 2 year renewable basis. The City of Vancouver is also currently undergoing a "neighbourhood review", wherein each area of the city is being reviewed with respect to the possibility of rezoning some RS-1 areas to permit legal suites. The City and District of North Vancouver and Surrey are also currently undergoing reviews of their policies towards secondary suites.

Do current policies limit the number of units being created? About 60 percent of owners of secondary suites indicated that municipal restrictions caused them some or a great deal of concern when they were deciding on renting out the unit. To the extent the survey is of those who decided to go ahead anyway, it is expected that some potential investors were so concerned that they did not go ahead.

Four out of 10 owners of secondary suites also felt that the presence of municipal restrictions against secondary suites would make their home more difficult to sell.

To the extent that potential investors in secondary suites are concerned about being "shutdown" in the future, the relative risk of rental housing is increased - this detracts from the relative attractiveness of this form of rental housing by requiring higher before-risk rates of return.

6.4.8.6 Conclusion - Municipal regulations likely a factor in escalation in land costs

The regulatory policies of local governments in Vancouver appear to have been a significant factor behind the shortages and higher prices for multiple land which have been experienced in recent years. In particular, the lack of pre-zoning for land appears to have added substantially to the costs and risks of development. Also, to

EXHIBIT 6-37

**LAND SALES BY SELECTED AREA
1989 AND 1990, VANCOUVER**

	Price Per Square Foot
City of Vancouver	\$91-117
Richmond	\$30-82
White Rock	\$19-29
Surrey	\$8-31
Abbotsford	\$2.75-6.68
Langley	\$1.50-4.50

Source: CMHC.

the extent that the lack of pre-zoned land available for development led to shortages in a time of high demand for multiple housing, this likely was a critical factor behind the escalation in multiple land prices in the late 1980s.

6.4.9 Lender Policies

Discussions with lenders and industry participants in 1990 indicated that lenders were positive towards rentals, but required significant equity - about 35 percent. The higher equity did not, however, reflect a change in underlying criteria - lenders still use a standard coverage ratio of revenue over debt service after expenses. Rather, it reflected the burden higher mortgage rates and project costs placed on net operating income.

Some conservative institutions are not recognizing the BCRSP subsidies in evaluating projects - they calculate the allowable loan based on net income exclusive of the subsidy. Also, the BCRSP attracted a number of "amateurs", but lenders looked less favourably on these investors.

6.4.10 Other Factors Also Impacted Rental Investment

6.4.10.1 Land costs driven up by strong condominium market

Prices for multiple land vary substantially across Vancouver. An examination of land sales in 1989 and 1990 in a sample of municipalities indicated that prices varied from a low of less than \$5 per square foot in Langley to a high of over \$100 per square foot in the City of Vancouver.

There have been two major factors which are widely believed to have impacted multiple land costs in the Vancouver area in recent years:

- The lack of pre-zoned land; and
- The competition for the limited supply of land afforded by the strength of the condominium market.

The former led to a shortage when the demand for multiple land increased. The latter caused an escalation in prices as the condominium market boomed, and, thereby, crowded out rental development which offered much less attractive returns.

The analysis of the impact of land availability on rental housing viability in the Vancouver market faces a major apparent paradox. There is a perceived lack of pre-zoned land and yet a recent study by Coriolis for the G.V.R.D. confirms that there is

EXHIBIT 6-38

POTENTIAL MULTIPLE LAND VANCOUVER, 1990

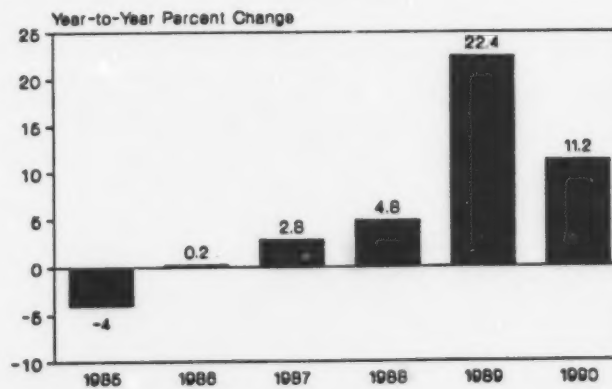
Municipality	Short-term*	Long-term*	Total
Surrey	72,300	0	72,300
City of Vancouver**	45,000	8,300	53,300
New Westminster**	12,000	0	12,000
Delta	11,000	0	11,000
Richmond	9,470	0	9,470
Burnaby	9,300	0	9,300
Maple Ridge	5,500	0	5,500
North Vancouver City**	3,500	0	3,500
Coquitlam	5,100	n.a.	5,100
Remainder	8,590	17,300	25,890
Total	181,760	25,600	207,360

* Short-term is defined as lands which are zoned and serviced or which could be readily rezoned and serviced. Long-term refers to lands which are designated for residential use but are generally not serviced.

** These are the only municipalities with any pre-zoned multiple land available.

Source: Coriolis Consulting, "Evaluation of Greater Vancouver's Land Supply", 1990.

EXHIBIT 6-39 SINGLE-FAMILY LAND PRICES VANCOUVER



Source: Statistics Canada

an overall supply of land for some 200,000 multiple units.⁷⁴ Why does this not translate into a land market viable for rental housing?

The Coriolis report, while valuable as an identification of the strategic supply of land in the Region, is less clear on the zoning status of these lands. It would appear in practice that the potential supply of **zoned** land in the metropolitan area is concentrated in the City of Vancouver and New Westminster. These lands, however, are generally already occupied by improvements, often multi-family residential, though they are developed below the density the zoning may allow. While these sites present potential redevelopment prospects for condominiums, their value would generally be in excess of the value required for a viable rental housing project.

The City of Vancouver and City of New Westminster account for 31 percent of the potential short-term supply identified by Coriolis. Surrey, on the other hand, accounts for 40 percent of the potential short-term supply. This land, in contrast to the supply in the urban area, will require rezoning on a project specific basis. Surrey is the major land resource for growth in Vancouver and in the development cycle is subject to great pressures for project approvals. This short-term pressure can translate into a protracted approvals process.

In summary, although there is a significant **potential** supply of multi-family residential land in the metropolitan area, this is largely subject to a pre-zoning approval, or it has an existing development with a value that would preclude its development for rental housing.

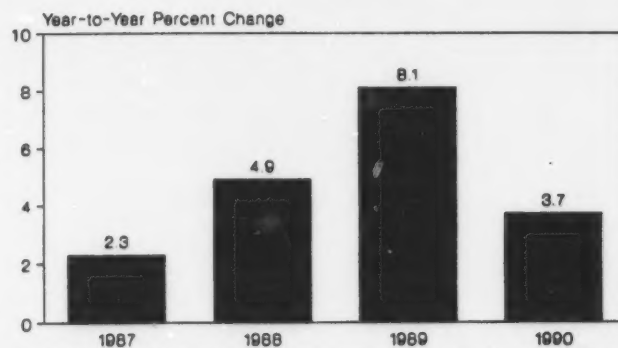
The shortage of pre-zoned land is considered to have contributed significantly to higher prices for the pre-zoned sites. The land by its nature is attractive - it generally forms part of existing neighbourhoods, is close to existing services and in some cases is located in high amenity areas, easily accessible to the downtown core; its pre-zoned designation acts further to elevate prices.

The generally low levels of rental construction in recent years have not contributed to pressures on the land market. However, the burst of activity in the condominium market in recent years combined with the shortage of pre-zoned sites resulted in a significant escalation in land prices in Vancouver. The competition for land from the condominium sector has resulted in land prices that generally only made sense for condominium construction.

Data on increases in multiple land costs are not available; however, information on the price of serviced lots for single-detached housing shows that the resurgence in the housing market led to a 22 percent increase in price in 1989 over 1988, and only an 11 percent increase in 1990. The price rise for multiple land was likely even greater given the strength in the condominium market. With condominium starts in 1989 nearly four times the number started in 1985, and a further increase in starts in 1990, there was intense competition for the available sites.

74 Coriolis Consulting, *Evaluation of Greater Vancouver's Land Supply*, a report prepared for the Greater Vancouver Regional District, May, 1990.

**EXHIBIT 6-40
APARTMENT CONSTRUCTION PRICES-
VANCOUVER**



* Based on contractors selling prices, assuming they were bidding on a 7-storey, reinforced concrete apartment structure with 53 units. Land and soft costs are excluded.

Source: Statistics Canada.

It appears that multiple land prices in 1990 levelled off due to an oversupply in the condominium market. Unless substantial declines occur, however, the prices will remain outside the reach of most rental investment. Rental projects are generally only feasible where the developer has held the land for some period of time and can include the increased value as part of the equity for the project. If land has to be purchased and financed at current prices, the return is not attractive.

In summary, high land costs, due to a combination of the lack of pre-zoned land and competition from the condominium sector, priced multiple land out of the reach of most rental projects in the late 1980s and 1990.

6.4.10.2 Construction costs rose rapidly due to demand for all types construction

Construction costs in Vancouver rose substantially in the late 1980s. CMHC estimates indicate that construction costs increased by about 18 percent in the two years prior to mid 1990. Statistics Canada's apartment construction price index shows smaller, but still substantial increases. The cause of the increase has largely been the strong demand for construction which resulted from the economic upturn which spurred demand not only in the residential sector but the commercial and industrial sectors as well.

Construction costs can be negatively impacted by the common practice of strata-titling rental buildings, as additional features and size variations may be included to enhance future saleability. Although this may negatively impact current returns by reducing cash flow (if extra costs are not recoverable in higher rents), there is the expectation of enhanced future returns through capital appreciation.

6.4.10.3 Higher return for developers in condominium projects

For developers, rental buildings and condominiums represent alternative investment vehicles. Interviews with industry officials in 1990, indicate that while the economics of rental investment were unattractive in 1990 due to elevated land and construction costs and interest rates, the strength in the condominium market still made condominium development a profitable enterprise.

A study of development alternatives for a site in the City of Vancouver's Kerrisdale neighbourhood illustrates the relative returns available on rental versus condominium investment in the late 1980s.⁷⁵ The alternative investments examined here are the following:

75 Danny Ho, *An Investigation of the Impact and Rationale for Rental Apartment Demolitions in Vancouver's Kerrisdale Neighbourhood*, A Masters Thesis, University of British Columbia, 1989.

EXHIBIT 6-41
COMPARISON OF RETURNS ON RENTAL
VERSUS CONDOMINIUM DEVELOPMENT, KERRISDALE

	<u>As Rental</u>	<u>As Condominium</u>
Units	26	26
Construction cost/sq. ft	\$90	\$100
Soft costs as % of construction cost	15	15
	\$ Million	
Land cost	3.6	3.6
Construction cost	4.8	5.3
Parking	0.6	0.6
Soft costs	0.8	0.9
Interim financing	0.9	1.2
Real estate commissions	-	0.7
Total cost	10.7	12.3

Rental Performance:

	\$Millions
Net operating income before debt	0.46
Property value:	
At 6.5% cap rate	7.1
At 5.5% cap rate	8.4
At 4.5% cap rate	10.2
At 3.5% cap rate	13.1
Return on investment:	
At 6.5% cap rate	(3.6)
At 5.5% cap rate	(2.3)
At 4.5% cap rate	(0.5)
At 3.5% cap rate	2.4

Condominium Performance:

Gross revenues (\$Millions)	18.1
Before tax profit: (\$Millions)	5.8
Return on equity: (20% equity)	236%
After tax profit (\$Millions): (at .46 tax rate)	3.1

Source: Danny Ho, "An Investigation of the Impact and Rationale for Rental Apartment Demolitions in Vancouver's Kerrisdale Neighbourhood, 1989", (A Master's Thesis).

- Building a new luxury high-rise building for sale to an investor as rental; or
- Building a condominium high-rise for sale to owners.

The project is based on an actual site purchased in Kerrisdale in 1988 with an existing rental property. Land costs are assumed to be the same for both projects (the price actually paid by the buyer) - \$126 per square foot.⁷⁶ Construction costs are somewhat higher for the condominium project (\$100 per square foot compared to \$90 for the rental project).

- As a rental project, total development costs are estimated at \$10.7 million. Based on an average rent per unit of \$2,175 per month (on a 1,740 square foot unit) and allowing for operating costs, net operating income is estimated at \$460,000 per year. The average capitalization rate for recent sales of existing rental buildings in Vancouver (presented in section 6.2.5.) was 6.6 percent; at this rate, the building would be worth less than \$7.1 million - over \$3.6 million less than it cost to develop. At the higher capitalization rates prevailing in other cities in Canada, the project would make even less sense. It would take a capitalization rate of 4.5 percent for the developer to cover the cost of the project - with no allowance for profit. This is clearly not an attractive investment opportunity.
- As a condominium development, the project looks much more attractive. Total development costs are estimated at \$12.3 million - the cost of building for condominium sale is generally higher than for the rental building plus there are items such as sales commissions and a longer period in which interim financing is required. Assuming an average sale price of \$400 per square foot or \$696,000 (the building is a luxury condominium), the gross revenues from the sale of the units are \$18.1 million. This yields a pre-tax profit of \$5.8 million - over 30 percent of the gross revenues.

The economics of this project work even at substantially lower prices. At \$300 per square foot, the gross revenues from the sale of the units would be \$13.6 million. This would still yield a pre-tax profit of \$1.3 million - slightly less than 10 percent of the gross revenues.

The large units (and high rents) assumed in the above example are from the Ho study. There is some doubt in the minds of the consultants whether there is a market for such units; however, the economics of a smaller unit are not significantly different. The rent per square foot in the Ho study was \$1.25; for Project V-3 in Exhibit 6-14 (Section 6.2.3) the rent per square foot was \$1.18 - very little difference. Construction costs in Project V-3 were somewhat lower (\$1.31 per square foot including soft costs and profit versus \$1.56). Land costs for Project V-3 were \$35,000 per unit; in the Ho study, the equivalent per unit land cost of a similar-sized suite

76 Ho estimated that the price in late 1989 would have increased by about 19 percent, to \$150 per square foot but this is not included in the analysis.

**EXHIBIT 6-42
DETERMINATION OF BUDGET FOR LAND
FOR CONDOMINIUMS, KERRISDALE**

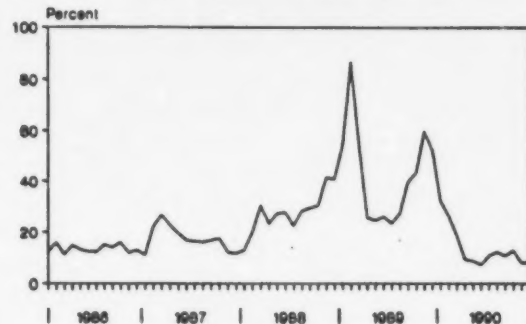
Number of Units	26
Buildable Area (Sq.ft.)	53,239
	\$Millions
Revenue	18.1
Costs (excluding land):	
Construction*	5.9
Profit (@ 20%)	3.6
Other**	2.1
Total	11.6
Revenues less costs (=residual to cover land)	6.5
Land carrying costs	1.1
Maximum budget for land	5.4
	\$
Maximum budget for land per sq.ft.	189
Actual price paid per sq.ft.	126

* Includes hard costs, parking and demolition of existing building.

** Includes soft costs, interim financing and real estate commissions.

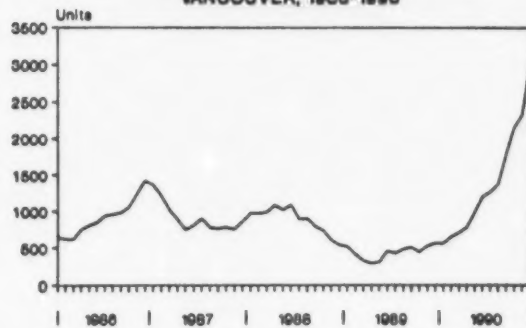
Source: Danny Ho, "An Investigation of the Impact and Rationale for Rental Apartment Demolition in Vancouver's Kerrisdale Neighbourhood, 1989", (A Master's Thesis).

**EXHIBIT 6-43
SALES/ACTIVE LISTINGS RATIO
APARTMENTS, VANCOUVER, 1986-1990**



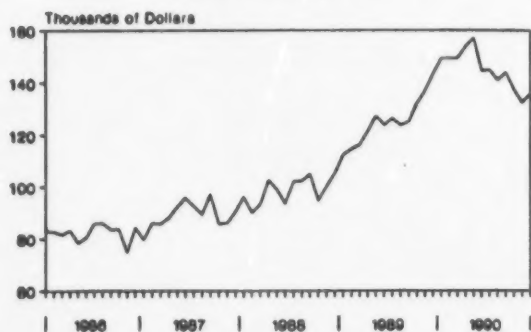
Source: Real Estate Board of Greater Vancouver.

**EXHIBIT 6-44
NEWLY COMPLETED AND UNOCCUPIED
CONDOMINIUM ROW AND APARTMENTS
VANCOUVER, 1986-1990**



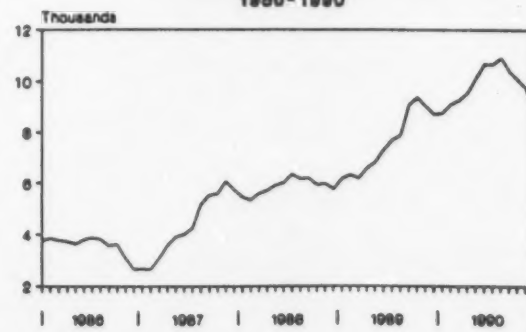
Source: CMHC.

**EXHIBIT 6-45
AVERAGE MLS APARTMENT PRICES
VANCOUVER, 1986-1990**



Source: Real Estate Board of Greater Vancouver.

**EXHIBIT 6-46
ROW AND APARTMENT UNITS UNDER
CONSTRUCTION, VANCOUVER
1986-1990**



Source: CMHC.

was somewhat higher at \$41,000. In general, the analysis in the Ho study confirms the relative lack of attractiveness of a given site as a rental project versus a condominium project.

The analysis for the same project can be approached slightly differently to show how condominium developers can compete more readily for land than rental developers. Assume the developer has a profit target of 20 percent of sales revenues. Total costs for the project, excluding land, are estimated at \$11.6 million. The residual from total revenues (\$18.1 million) and total land is \$6.5 million. After allowing for carrying charges on the land, the **maximum** budget available for land is \$5.4 million, if the profit target is to be achieved. This translates into a maximum of \$189 per square foot of site area that the developer would have been willing to pay; as the developer only had to pay \$126, he would make even greater than a 20 percent profit on the project - assuming that the units sell for the estimated price.

In summary, therefore, given the market that existed for condominiums in Vancouver in recent years, it seems clear why developers have favoured this product over rental properties.

6.4.10.4 But condominium activity has slowed

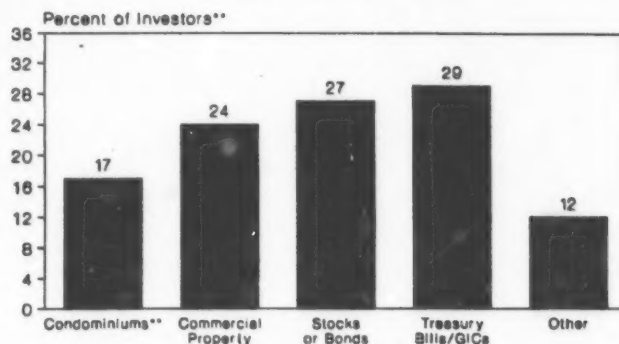
Clearly the boom in the condominium market in Vancouver had a significant crowding out influence on the conventional rental market. The prices of the limited supply of available land were bid up as ever greater quantities of condominium units were built. Not only did this increase the costs of rental development, but, at the same time, it was evident to multiple housing developers that there were much greater returns to be had in condominium development than in rental development.

This seems unlikely to continue. The condominium boom in Vancouver abated in late 1990: sales declined, listings rose, the number of unoccupied new units increased significantly and prices fell. While the condominium market recovered to some extent in early 1991, it seems unlikely that the high levels of condominium construction activity experienced in 1989 and 1990 will continue in 1991.

The slowdown in activity in the condominium market is good news for the rental market in Vancouver. On the one hand, the unsold condominium units that are in the hands of both investors/speculators and developers have, as evidenced in the latest vacancy numbers, provided an additional source of supply for the rental market. On the other, the less buoyant prospects for the condominium market are likely to result in less pressure on both land and construction costs so, at a minimum, the costs of building new conventional rental units are unlikely to increase significantly in the near future.

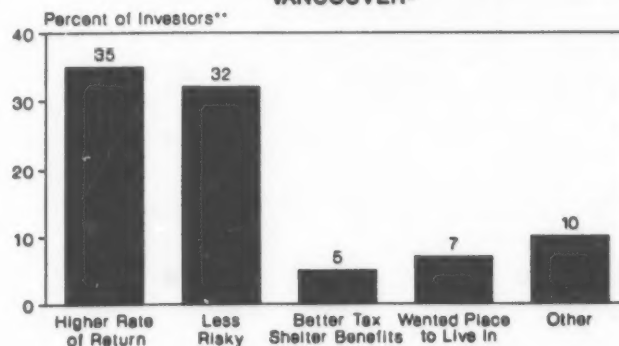
The news could be even better to the extent that many developers have likely been planning to build more condominium projects, have the land in the development approvals process, and now are unlikely to proceed to construction given the slowdown in the condominium market. The result of this could be increased supplies

**EXHIBIT 6-47
TYPES OF ALTERNATIVE INVESTMENT
CONSIDERED, VANCOUVER***



* Investors in non-conventional units.
 ** Multiple responses were possible.
 *** Excludes those who invested in condominiums.
 Source: "Survey of Rental Investors, Vancouver".

**EXHIBIT 6-48
REASONS FOR CHOOSING
RENTAL INVESTMENT OVER OTHER INVESTMENT
VANCOUVER***



* Investors in non-conventional units.
 ** Multiple responses were possible and not all respondents provided a reason.
 Source: "Survey of Rental Investors, Vancouver".

of vacant available multiple land which could be used for either rental or condominium - if the increase in supply is large, as seems possible, there could be downward pressure on land prices. This, plus possible cost-cutting on the part of both contractors more hungry for work than during the condominium boom, developers willing to look seriously at projects with less potential profit than was available (in the past) from building condominiums and the decline in interest rates, all improve the economics of conventional rental investment. The increase in vacancy rates in early 1991, however, would likely dampen developers' enthusiasm for rental investment (even if the returns were attractive) until vacancy rates decline again.

6.4.10.5 Most investors in non-conventional rental housing considered other investments, but felt rental was less risky and provided higher rates of return

Investors in non-conventional rental housing were asked whether they had considered alternative investments. Almost 80 percent had considered at least one alternate type of investment. Almost all investors in condominiums considered alternative investments (95 percent), while a somewhat smaller proportion of investors in secondary suites did so (70 percent). The types of alternate investments considered varied widely - between 24 and 29 percent of respondents said they had considered investing in commercial property, buying stocks/bonds or buying treasury bills/GICs. About 1 in 6 investors in houses and secondary suites said they had considered buying a condominium instead.

Investors chose rental investment over these alternate types of investment because they generally perceived it as providing a higher rate of return and being less risky.

6.5 CONCLUSION - LITTLE CONVENTIONAL RENTAL INVESTMENT BECAUSE THE ECONOMICS JUST DIDN'T WORK

It is not surprising that there was little new conventional rental investment in Vancouver in the second half of the 1980s and 1990. Despite the positive impetus from the demand side (in-migration which led to lower vacancy rates and rising rents), higher costs brought on by competition from the condominium sector plus higher interest rates more than offset the beneficial impact of higher rents on the economics of conventional rental investment. The result, predictably, was little new conventional rental investment that was not heavily subsidized - either public sector housing or projects promoted by the interest subsidies from the B.C. Rental Supply Program.

That is, of course, not to say that there was no rental investment. There were a substantial number of units created by individuals either through the installation of secondary suites in their homes or by investing in a condominium or house that they rented out. An estimated 28,500 additional rental units were created in Vancouver from these non-conventional sources over the 1985-1989 period.



A

In terms of the criteria established for assessing efficiency in the rental market (Section 2.4), it appears that actors were responding in a rational manner to market signals:

- For developers, the economics of rental investment offered nowhere near the types of returns available from development and sale of condominium projects. Therefore, they concentrated on this market; to do otherwise would be irrational.
- For individuals, the potential capital gains from investing in a house or condominium in a rising real estate market were very attractive. They responded by increasing investment in non-conventional rental housing.
- Other individuals sensed an opportunity to gain income through renting out secondary suites.

The rental market responded rationally: those for whom investment was attractive (non-conventional investors) responded by supplying additional units; those for whom investment was not attractive (developers of conventional rental housing) did not. The unexpected strength of the non-conventional supply (combined with the effects of the recession on demand) was even sufficient to raise conventional apartment vacancy rates to 2.3 percent in April, 1991.

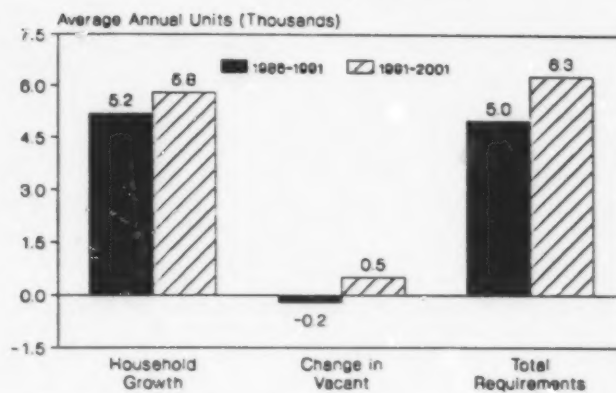
In terms of government intervention possibly creating inefficiency in the rental market, two instances appear particularly relevant to Vancouver:

- The reluctance of municipalities to pre-zone land is considered to be a major factor behind the shortages, and resulting escalation of costs, of multiple land.
- Municipal regulations restricting the creation of secondary suites likely reduced the volume of supply of additional rental housing from this source.

On the other hand, the introduction of the \$100,000 personal exemption from capital gains tax was a government intervention which likely had the (unintended) impact of stimulating investment in rental houses and condominiums.

For the future, the prospects for the Vancouver rental market appear more promising. With lower levels of condominium activity, it seems likely that the pressures for ever-higher costs that characterized the late 1980s will abate. It is possible that there could be significant declines in land and construction costs to the extent that the oversupply in the condominium market forces developers and contractors to look for alternatives in a much weaker market. Another positive factor for rental investment is the decline in interest rates; this could have a major beneficial impact on the economics of rental investment in the next few years as vacancy rates decline.

EXHIBIT 6-49
RENTAL HOUSING REQUIREMENTS
VANCOUVER, 1991-2001



Source: Projections by Clayton Research Associates.

Of course, the environment for rental investment will also be impacted by the volume of rental housing requirements; future requirements for rental housing in Vancouver are examined in the next section.

6.6 FUTURE RENTAL HOUSING REQUIREMENTS

This section examines the likely level and composition of rental housing requirements in Vancouver over the next decade.

6.6.1 Rental Housing Requirements Expected to Average About 6,300 Units Per Year in 1991-2001

Projections prepared by Clayton Research Associates and CitySpaces Consulting for the Greater Vancouver Regional District indicate that rental housing requirements in the Vancouver CMA will average about 6,300 units per year in 1991-2001 compared to about 5,000 units per year in 1986-1991.⁷⁷

These projections were based on a consideration of the underlying age structure of the population as well as age-specific propensities to form households and to rent versus own. The projections also incorporate the following key assumptions:

- Net migration is assumed to average about 24,000 per year in 1991-2001, compared to 22,000 per year on average in 1986-1991.
- Headship rates are assumed to remain constant at 1991 propensities in the first half of the 1991-2001 period and there is a modest shift to rental tenure, in response to the sharp rise in house prices in recent years. In the latter half of the period, there is assumed to be a modest shift back to homeownership and modest increases in overall household headship rates.
- These assumptions, combined with the age structure of the population, result in total renter household growth of about 5,800 per year in 1991-2001.

Allowing for 2 percent vacancies, total rental housing requirements are expected to be roughly 6,300 units per year on average in 1991-2001.

77 Clayton Research Associates and CitySpaces Consulting, *Recommendations for An Affordable Rental Housing Strategy*, a report prepared for the Greater Vancouver Regional District, 1990. Several scenarios of demand were formulated, based on varying assumptions with regard to net migration, headship rates, and tenure propensities. The numbers referred to in the present study represent the "best estimate" scenario. Readers interested in more detailed information on these projections are directed to Appendix B of the GVRD report.

**EXHIBIT 6-50
RENTER HOUSEHOLD GROWTH BY HOUSEHOLD
TYPE, VANCOUVER, 1991-2001**

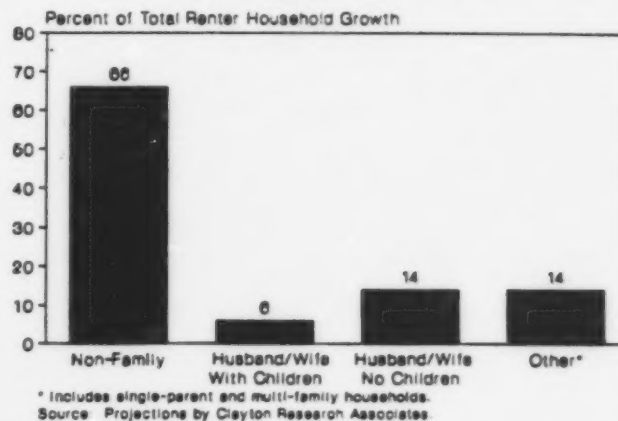


**EXHIBIT 6-51
RENTER HOUSEHOLD
AVERAGE INCOME BY TYPE OF
HOUSEHOLD, CANADA, 1988**

	<i>Dollars</i>
<u>One-Person Households</u>	
Under 65 years of age	21,262
65 years of age and over	13,880
Total	19,006
<u>Family Households</u>	
Husband/wife families with no children	35,278
Husband/wife families with children*	37,846
Lone-parent households*	16,821
Total	33,965
All Renter Households	28,328

* With children under the age of 18 years at home.
Source: Statistics Canada.

6.6.2 Renter Household Growth Expected to Be Dominated By Non-Family Households

Non-family households have historically accounted for the lion's share of renter household growth in Vancouver. Non-family households accounted for 75 percent of household growth in the 1976-1981 period and 52 percent in 1981-1986, according to Census of Canada information. It is estimated that this proportion increased substantially in the 1986-1991 period, the result of an increase in non-family headship rates following declines in these headship rates in some age groups in the 1981-1986 period.

Given the basic demographic profile underlying the projections and the assumptions about family and non-family headship rates, the predominant growth group in 1991-2001 is once again non-family households. These households are projected to account for about two-thirds of rental household growth in the next decade. Couples without children and "other" households (predominantly single-parent families) are each expected to account for just under 15 percent of growth; the remainder is expected to be comprised of couples with children.

6.6.3 Incomes Lowest for One-Person and Single-Parent Households

Renters in general have lower incomes; in 1988, the average renter household in B.C. had income of only about 60 percent of that of the average owner household - \$27,462 compared to \$45,348.

Average incomes also vary widely among different types of renter households. As would be expected, average incomes are much lower for one-person renter households than for families (excluding single-parent families). Canada-wide income statistics are used to illustrate this point. The average income of one-person renter households was only about \$19,000 in 1988 or 56 percent of the average renter family household income of \$33,965. Seniors have a considerably lower income than non-senior one-person renter households - \$13,880 versus \$21,262 for Canada in 1988.

Within the family renter household category, lone-parent families have very low incomes compared with husband-wife families with or without children at home. The average lone-parent family in Canada in 1988 had an income even lower than the average single person renter household under the age of 65 years - \$16,821 versus \$21,262. The fact that a significant proportion of lone-parent families are on social welfare contributes to these low incomes.

There is no reason to believe that these relative differences in incomes by household type for Canada are not reflected in Vancouver as well.

6.6.4 Some Shift in Requirements to More Affordable Product Likely in 1991-2001

It was not part of the mandate of this study to prepare projections of rental housing requirements by rent range. However, with about 80 percent of demand in the 1991-2001 period expected to be comprised of those household types with relatively lower incomes **on average** (i.e. non-family and lone-parent households), it is apparent that there is likely to be some shift in rental requirements in the period towards "affordable" product.⁷⁸

Social housing will need to accommodate some of these requirements for affordable rental housing; however, at the levels experienced in recent years (approximately 1,400 units per year in 1985-1989) this will fill only about one-fifth of total rental requirements. The remainder would have to be addressed by units created from within the existing stock or the construction of privately-initiated units.

Secondary suites are a prime source of lower-rent supply, but this potential is currently artificially limited due to municipal policies which restrict these types of units. Unless these policies were to change, there is unlikely to be an increase in the number of units created annually above the 2,000 per year estimated for the 1986-1991 period.

Although the current oversupply in the condominium market may see more of these units coming onto the rental market, their higher rent levels do not generally make them appropriate for lower-income non-family or single-parent households; they will, however, be potential supply for the portion of the household growth that is expected to be couples with and without children.⁷⁹ Also, to the extent that they attract higher-income tenants away from existing lower-rent units, these units will become available for lower-income tenants. The increase in vacancy rates in conventional rental units in early 1991 is evidence that this is occurring.

78 This is not to say that all requirements within these household types will be for lower-rent units; for example, many non-family households are comprised of two or more unrelated persons with combined incomes that could support higher-rent units.

79 The survey of rental investors in Vancouver showed that about three-quarters of rented condominiums were occupied by couples with or without children; less than 50 percent of secondary suites were occupied by couples.

CHAPTER 7

OVERALL REVIEW OF REASONS FOR DIFFERENT TRENDS IN THE FIVE RENTAL MARKETS

This chapter provides an analysis of the differences in the rental investment environments in Calgary, London, Winnipeg, Montreal and Vancouver which can explain the apparent differences in the supply responses in these centres in recent years to the signals in the market. The analysis draws heavily on the reviews of the rental markets in each of these centres presented in Chapters 4-6 of this study.

The five centres can be combined into two groups for purposes of discussing the reasons behind recent rental market performance:

- **Centres with a rent controlled environment, but which have still had significant rental construction in recent years - Montreal, London and Winnipeg**
- **Centres with no rent controls and rising rents, yet little new rental construction in recent years - Calgary and Vancouver**

The focus in this chapter is on private investment in conventional, rather than non-conventional, construction. The chapter first reviews the economics of rental investment in each centre in 1990 using the pro formas for typical projects developed in earlier chapters. Next, the decision-making environment in each market is examined in terms of how each of the components of overall return on investment (from Chapter 2) is impacted by the peculiar situations in each market. Finally, the chapter reviews the major factors which encouraged or discouraged rental investment in each centre - the focus is on why the private sector has or has not made rental investments in conventional rental projects.

7.1 A COMPARISON OF THE ECONOMICS OF RENTAL INVESTMENT IN THE FIVE CENTRES

7.1.1 Negative Returns on New Construction in All Centres at 13 Percent Mortgage Interest Rates

Exhibit 7-1 provides a comparison of the pro formas for a typical project in each centre in 1990. The type of project selected for each centre has already been reviewed in the relevant sections of this report. The information, however, has been adjusted so that all cases reflect a standard 800 square foot unit built in 1990, 25 percent equity and a 3 percent vacancy allowance (the vacancy rate assumed in the pro forma analyses). In general, the projects in each centre are considered to be representative of typical standard accommodation located in a suburban area with good access to the downtown.

EXHIBIT 7-1

PRO FORMA OF RENTAL INVESTMENT, 5 CENTRES*

Project Type Unit Size (Sq. Ft.)	Centres with Significant Recent Rental Construction			Centres with Relatively Little Recent Rental Construction	
	Montreal	London	Winnipeg	Calgary	Vancouver
	Low-Rise 800	Mid-Rise 800	Low-Rise 800	Low-Rise 800	Low-Rise 800
Project Cost			(\$ per unit)		
Land	10,875	9,500	4,700	9,150	29,715
Construction and Soft Costs and Profit	45,850	63,000	49,850	59,425	73,715
Total Project Cost	56,725	72,500	54,550	68,575	103,430
Project Financing					
Total Project Cost	56,715	72,500	54,550	68,575	103,430
Mortgage	42,535	54,400	40,915	51,425	77,570
Equity	14,180	18,100	13,635	17,150	25,860
Annual Revenues and Costs					
Gross Income	6,015	8,745	7,460	8,460	9,775
Operating Costs	1,640	3,000	2,490	2,740	2,855
Net Operating Income	4,375	5,745	4,970	5,720	6,920
At 13% Mortgage Rate					
Mortgage Payments	5,630	7,200	5,415	6,805	10,265
Net Income					
First Year	(1,255)	(1,455)	(445)	(1,085)	(3,345)
Fifth Year**	(510)	(480)	400	(115)	(2,170)
At 11% Mortgage Rate					
Mortgage Payments	4,915	6,285	4,730	5,945	8,965
Net Income					
First Year	(540)	(540)	240	(225)	(2,045)
Fifth Year**	205	435	1,085	745	(870)
Total Costs Per Square Foot (\$)	71	91	68	86	129
Land as % of Total Project Cost	19	13	9	13	29
Net Operating Income as % of Project Cost	7.7	7.9	9.1	8.3	6.7

* For Calgary, London and Winnipeg, the selected project is the typical project provided by CMHC; for Montreal, it is project M-1 and for Vancouver, project V-2. Data have been adjusted to reflect an 800 square foot unit, 25% equity and 3% vacancy allowance.

** Assumed rate of growth for each centre is 4 percent annually.

Source: Clayton Research Associates based on information from CMHC and other sources.

Highlights of the differences among the centres revealed in these pro formas include the following:

- **Project costs** - at over \$100,000 per unit, Vancouver's project costs were by far the highest of the five centres. Both land and construction costs were significantly above those of the other centres. London (\$72,500) and Calgary (\$68,575) had the next highest costs while Winnipeg and Montreal both had substantially lower costs.

On a per square foot basis, costs ranged from a low of \$68 in Winnipeg to \$129 in Vancouver. Although both land and construction costs were relatively higher in Vancouver, land was disproportionately so.

- **Initial investment required** - the lower average project costs in the three centres with significant recent construction compared to Vancouver means that investors could get into the market with smaller initial investments. This is particularly true in Montreal, where not only was the per unit project cost relatively low, but very small buildings (e.g., 8 or less units) were very common.
- **NOI as percent of project cost** - net operating income (NOI) as percent of total project cost was higher in the centres that had significant rental construction than in Vancouver - this ranged from 9.1 percent in Winnipeg to only 6.7 percent in Vancouver.
- **Net income** - at a 13 percent mortgage interest, the typical project in none of the centres exhibited positive net income in the first year of operation. However, at an 11 percent mortgage interest rate, the losses would be substantially reduced - in Winnipeg, in fact, there would be a positive cash flow of \$240. In the fifth year, the economics of the projects in all centres except Vancouver improve significantly. At 11 percent mortgage interest rates, projects in the other four centres all generate a positive cash flow.

The pro forma information presented in Exhibit 7-1 provides a good illustration of the relative economics of rental construction in each centre in 1990. Several points appear particularly pertinent:

- Rental investment in Vancouver, even at 11 percent interest rates, would generate a large negative cash flow even after five years. Given the attractive returns available from condominium development, it is not surprising that little conventional rental housing was built.
- The economics of rental investment were much more attractive in the other four centres. At an 11 percent interest rate, the projects all would generate a positive cash flow after the first few years.

EXHIBIT 7-2

CHANGES IN FACTORS REQUIRED TO ACHIEVE A ZERO NET INCOME SITUATION IN THE FIRST YEAR

Alternative Scenarios*	Centres with Significant Recent Rental Construction			Centres with Relatively Little Recent Rental Construction	
	Montreal	London	Winnipeg	Calgary	Vancouver
<u>At 13% mortgage rate</u>					
<u>Assuming Increased Equity</u>					
Current Level (at 25% of Costs)	14,180	18,100	13,635	17,150	25,860
Required Level	23,671	29,096	17,001	25,360	51,148
Increase	9,491	10,996	3,366	8,210	25,288
Equity as % of Total Costs	42	40	31	37	49
<u>Assuming Lower Project Costs Per Square Foot</u>					
Current Level	71	91	68	86	129
Required Level	55	72	63	72	87
% Change	(22)	(20)	(8)	(16)	(33)
<u>Assuming Higher Gross Income</u>					
Current Level	6,015	8,745	7,460	8,460	9,775
Required Level	7,270	10,200	7,905	9,545	13,120
% Change	21	17	6	13	34
<u>At 11% mortgage rate</u>					
<u>Assuming Increased Equity</u>					
Current Level (at 25% of Costs)	14,180	18,100	13,635	17,150	25,860
Required Level	18,866	22,786	11,542	19,077	43,548
Increase	4,686	4,686	(2,093)	1,927	17,688
Equity as % of Total Costs	33	31	21	28	42
<u>Assuming Lower Project Costs Per Square Foot</u>					
Current Level	71	91	68	86	129
Required Level	63	83	72	82	100
% Change	(11)	(9)	5	(4)	(23)
<u>Assuming Higher Gross Income</u>					
Current Level	6,015	8,745	7,460	8,460	9,775
Required Level	6,555	9,285	7,220	8,685	11,820
% Change	9	6	(3)	3	21

* Required change in each factor assuming all other factors remain constant.
Source: Clayton Research Associates.

- Rental investment in Calgary appears to be relatively attractive at 11 percent interest rates. As noted in Chapter 4, developers were looking at the Calgary rental market before interest rates rose in 1990.

7.1.2 What Would Be Required to Make Rental Investment More Attractive?

Exhibit 7-2 illustrates what would be required to reduce negative income to zero in the first year of the typical rental projects in Exhibit 7-1. Four types of changes are examined specifically:

- Lower interest rates;
- Higher amounts of equity;
- Decreases in project costs; and
- Increases in gross income (i.e. rising rents).

In examining the change in each factor necessary to reduce negative cash flow to zero, it is assumed that the other factors remain constant; for example, the higher gross income scenario indicates the percent increase in rents which would be required to achieve zero net income, **assuming that project costs and equity remain the same.**

In analyzing this information, it is important to stress that zero net income in the first year is used as a benchmark for illustrative purposes only. It is clear from the analysis in earlier chapters that, **depending on the returns available from other investments** as well as individual circumstances, investors may be willing to accept a moderate negative cash flow in the early years if there are prospects for an improvement. The extent of negative cash flow (and the timing of achievement of positive cash flow) which investors would be willing to accept would be dependent on investors' alternatives and individual circumstances. So the estimated change required to achieve zero net income should be considered to be **illustrative only** - smaller changes may be sufficient.

Also, the analysis does not take account of the current situation in rental markets in each centre. Vacancy rates of 3 percent are **assumed**. Since vacancy rates in four of the centres were above this level in April, 1991 (Calgary: 4.2 percent; London: 4.0 percent; Montreal: 5.6 percent; and Winnipeg: 5.8 percent), it is unlikely that new rental projects would be attractive in these centres until vacancy rates declined.

The discussion focuses mainly on the results assuming 11 percent mortgage rates. In Winnipeg, the drop in interest rates alone is sufficient to turn net income positive.⁸⁰ For the other centres, the following scenarios would be required to achieve even a zero net income:

80 As discussed, this is unlikely to result in significant new rental investment in Winnipeg in the short-term since the vacancy assumption in the pro forma is only 3 percent - unlikely in the current rental market in Winnipeg.

- **Equity** - equity would need to be in the range of 30 percent for Montreal, London and Calgary, but still above 40 percent for Vancouver to achieve zero net income with 1990 project costs and revenues at an 11 percent mortgage rate.

An increase in equity has a more significant impact on the rate of return than the other factors examined in Exhibit 7-2. Increases in rents or declines in project costs are "pure" enhancements to the rate of return - they lead to a higher rate since the investment remains constant. However, a higher equity contribution with the same overall return will reduce the rate of return on investment.

The reduction in required equity from the 40 percent range to the 30 percent range with the drop to 11 percent interest rates in Montreal, London and Calgary could, in itself, be sufficient to stimulate interest among some investors, assuming the rental market environment was positive. To the extent that developers may have land which is sitting idle - a non-producing asset - or unemployed building resources, the opportunity cost of providing this slightly higher than normal share of equity could be low.

- **Project costs** - project costs would have to be between 4 and 11 percent lower in Montreal, London and Calgary to achieve a zero net income situation at 11 percent mortgage rates - if all other factors are held constant. In Vancouver, however, a decline of almost 25 percent would be needed. Although, of all the centres, Vancouver is most likely to experience **some** real cost declines in the near future (given the escalation in land and construction costs in recent years, and the easing in real estate markets), a decline to this degree appears highly unlikely.
- **Gross income** - rent increases between 3 percent and 9 percent would be required in each of Montreal, London and Calgary to improve the net income picture to zero at an 11 percent mortgage rate. In Vancouver, however, a much more substantial increase of roughly 20 percent would be required.

In summary, mortgage interest rates of 11 percent alone could be sufficient to generate positive net income for the typical Winnipeg project - assuming 3 percent vacancy could be achieved. Except for Vancouver, the other centres would require only relatively modest changes in equity, costs or rents to achieve a balance between income and costs. As noted above, however, when vacancy rates decline in these centres, changes of the magnitude indicated may not be required to the extent that investors are willing to accept **some** negative cash flow in the early years.

In Vancouver, however, clearly larger adjustments would be required to make rental investment attractive. Any number of scenarios could be envisaged at 11 percent mortgage interest rates:

- Zero net income in the first year could be achieved with an increase in equity to 30 percent, a reduction in costs of 10 percent and a 6 percent increase in rents.
- Zero net income in the third year could be achieved with the following changes:

<u>Equity</u>	<u>Reduction in Costs</u>	<u>Increase in Rents</u>
30%	10%	0%
25%	10%	6%
25%	17%	0%
25%	7%	8%

With the reduced returns available from condominium development and lower costs due to less competition for land and construction, Vancouver developers might again have examined the potential in the rental market. However, recent rises in vacancy rates are likely to dampen rent increases and hence postpone conventional rental investment.

7.2 A COMPARISON OF THE RENTAL INVESTMENT ENVIRONMENT IN THE FIVE CENTRES

This section presents a review of the environment for rental investment in each centre over the period of the late 1980s and 1990. The analysis is based on the pro formas presented in the previous section and the reviews of the rental investment environment in each centre presented in Chapters 4-6. The analysis concentrates on the four determinants of the rate of return on rental investment:

- Size of initial investment;
- Cash flow;
- Tax position; and
- Expected capital appreciation.

As well as the relative returns and risk on alternative investments which were discussed in Chapter 2 - these are summarized in Exhibit 7-3. Since 13 percent interest rates were not prevalent in the late 1980s and the primary purpose here is to explain why investment occurred (or did not occur) in that period in each centre as well as to set the stage for a discussion of the future, the discussion focuses mainly on the situation if mortgage interest rates were 11 percent rather than 13 percent.

EXHIBIT 7-3

SUMMARY OF DECISION-MAKING ENVIRONMENT IN LATE 1980s

Determinant of Overall Rate of Return	Centres with Significant Recent Rental Construction			Centres with Relatively Little Recent Rental Construction	
	Montreal	London	Winnipeg	Calgary	Vancouver
Initial Investment Required	Modest negative net income at standard 25% equity and 11 percent mortgage rate and 3% vacancy rate Lower per unit costs and smaller building sizes means lower equity levels needed; encouraged small investors	Modest negative net income at standard 25% equity and 11 percent mortgage rate and 3% vacancy rate	Positive net income at standard 25% equity and 11 percent mortgage rate and 3% vacancy rate	Modest negative net income at standard 25% equity and 11 percent mortgage rate and 3% vacancy rate	Substantial negative net income at standard 25% equity and 11 percent mortgage rate and 3% vacancy rate
Cash Flow	Generally negative initially; expectations of positive over longer term	Generally negative initially; expectations of positive over longer term	Generally rents cover costs initially	Generally negative initially; expectations of positive over longer term but likely less so than other centres due to spectre of declining real rents in mid 1980s	Higher project costs than in other centres requires higher actual level of equity and as % of total costs to make project work
Capital Appreciation	General expectations of capital appreciation this in continuous expectation - rent controls not a concern	General expectations of capital appreciation though rent controls limit potential	General expectations of capital appreciation though rent controls limit potential	Generally very negative initially; expectations of positive over longer term	General expectations of capital appreciation
Tax Position	Buildings not generally promoted as tax shelters but may have made a difference in some marginal situations Introduction of \$100,000 capital gains exemption likely encouraged small investors and right product was available Syndications were mainly in relation to seniors' projects but these were sold mainly on premise of positive cash flow, not tax benefits	The promotion of syndicated rental buildings was an important factor in spur of rental construction; realized returns, however did not generally match the prospectus projections due to softer than expected market	Large proportion of new construction was of tax-driven syndicated projects	Potential investors in this market did not have same expectations of generally rising real estate values - they had seen real estate values drop in mid 1980s Tax shelter driven syndications occurring in the existing market, but not for new construction	Some syndications but the poor cash flow position of new construction in general not sufficiently enhanced by limited tax benefits
Relative Risk/Return on Other Investments	Investors perceived the risks of rental investment to be generally low and returns superior to other investments	The lack of volatility in the London economy perceived to minimize risk in rental investment No substantial market in London for condominiums, so little potential for developers to invest in this sector	Condominium market oversupplied, so not an alternative investment vehicle for developers	Risk of rental investment considered high given the collapse of the market in the mid 1980s	Return on condominiums significantly higher than for rental Lack of pre-zoned land increases risk of project, since not sure it will be able to proceed

Source: Clayton Research Associates, CitySpace Consulting and John Harbottle, Economists.

7.2.1 Higher Net Equity Than 25 Percent Required in Most Centres

At 11 percent mortgage interest rates and 25 percent equity, new rental projects in all centres except Winnipeg would suffer from a negative cash flow in the initial year at least. Thus, a higher equity commitment would be required though this could take any of several forms: contributions of land or construction at less than market rates, greater contributions of capital, letters of credit which guarantee the returns to lenders or second mortgages (or other loans).

In low cost centres such as Montreal and Winnipeg, the dollar amount of equity required is much smaller for a given sized property because of the overall lower costs of land and construction. In Montreal, the proliferation of small buildings makes investment within the means of individuals and small companies whereas in centres where large projects are the norm, only significant sized companies can contemplate such an investment.

In Vancouver, a much higher equity is required than in any of the other centres - in terms of both dollars and proportion of total costs. This acts to discourage investment in Vancouver compared to the other centres.

7.2.2 Negative Cash Flow the Norm

As discussed in the previous section, new rental projects in all centres except Winnipeg would suffer from negative cash flow in the initial years (with 25 percent equity, 11 percent mortgage rates and assuming a 3 percent vacancy rate). In general, this was acceptable for investors in Montreal, London and Winnipeg in the late 1980s, since there were expectations of future gains in net income which will ultimately generate a substantial increase in cash flow (or offsetting tax benefits). In Vancouver and Calgary, however, memories of declining real rents during parts of the 1980s tended to reduce the expectations of future rent increases and thus made investors less willing to proceed with projects with a negative cash flow. In Vancouver, the negative cash flow was very large.

7.2.3 Longer-Term Returns Expected through Capital Appreciation in Most Centres

Investors in most centres had expectations of longer-term returns through capital appreciation, so this factor does not help to explain the differences between centres that experienced substantial rental investment and those that did not. Rent controls in London and Winnipeg would have acted to constrain expectations of capital gains somewhat in those centres. In Montreal, however, the relatively benign form of rent control does not appear to constrain expectations of capital appreciation.

In Calgary, expectations of capital gains were more muted, as potential investors recalled that real estate values declined in Calgary in the mid 1980s and were



therefore less likely to accept that property values are always on the increase. In Vancouver, expectations of capital gains were insufficient to counter the substantial short-term operating losses and the attractiveness of the alternative investments available in condominium development.

7.2.4 Tax Benefits Important in Centres with Significant Recent Construction

Tax benefits were important factors behind the increase in rental construction in Montreal, London and Winnipeg in the late 1980s. The tax shelter aspect of rental investment was widely promoted in London and, to a somewhat lesser degree, Winnipeg. In Montreal, it was not so much the tax shelter aspect, but rather the introduction of the \$100,000 lifetime capital gains exemption - this encouraged small investors who were looking for longer-run returns. Also, some developers in all three centres took advantage of the positive tax treatment available from rental housing and built projects for their own portfolio.

In Vancouver, the benefits that could be afforded by tax considerations were generally not sufficient to overcome the substantial initial losses of projects. The capital gains exemption was, however, a factor in the increased non-conventional supply.

7.2.5 Risks Considered Low, Less Attraction to Alternative Investments in Centres with Significant Rental Construction

In all three centres with significant rental construction in the late 1980s, investors considered rental housing to be a fairly safe investment. As well, alternative investments for developers in condominiums were not a significant factor: in Winnipeg for example, the condominium market was oversupplied; in London there is no substantial market for condominiums. In addition, some of the developers investing in each of these markets considered rental investment as part of a well-diversified investment portfolio: while residential rental properties generally carry a lower initial rate of return than commercial or industrial rental properties, returns are more stable since one or two large tenants do not comprise a significant share of total income. Once established, residential rental properties are perceived by investors as a more stable investment.

In contrast, in Calgary, the risks associated with rental investment were considered to be quite high in the late 1980s, given the collapse in the rental market and the decline in real rents that occurred in the mid 1980s. In Vancouver, the strong condominium market and the substantially higher rates of return afforded by this investment vehicle made it in general more attractive to developers. The lack of pre-zoned land and the necessity of getting each rental project approved individually also increased the risk aspect of rental investment in Vancouver.

EXHIBIT 7-4

KEY FACTORS IMPACTING ON INVESTORS' DECISION TO INVEST/NOT INVEST IN RENTAL HOUSING

Centres with Significant Recent Rental Construction			Centres with Relatively Little Recent Rental Construction	
<u>Montreal</u>		<u>London</u>	<u>Winnipeg</u>	<u>Vancouver</u>
• General speculation in real estate • Tax benefits (\$100,000 capital gains exemption) • Presence of the small investor • Abundant land, little competition from condominium	• Tax shelters and favourable lender policies • Developers building for own portfolio • Perceived low risk • Abundant land, little competition from condominium	• Government incentive programs • Tax shelters • Developers building for own portfolio • Abundant land, little competition from condominium	• Perceived high risk • Rent rises not sufficient till 1990, then interest rates rise • Public policies especially lack of pre-zoned land	• High land and construction costs • Better rate of return on condominiums

Source: Clayton Research Associates, CitySpaces Consulting and Jules Hurtubise, Economiste.

7.3 KEY FACTORS BEHIND WHY CONSTRUCTION DID OR DID NOT TAKE PLACE

Exhibit 7-4 presents a review of the key factors behind why substantial rental investment occurred in some centres and not in others in the late 1980s.

Although Montreal, London and Winnipeg each had increased levels of construction despite rent controls and somewhat adverse market conditions, the major reasons why construction took place varied among the centres:

- In **Montreal**, the main reasons behind the upturn in rental starts in the 1985-1987 period appear to be the general fever of speculation in real estate that accompanied the economic upturn and declines in mortgage rates, combined with the widespread belief that rental investment was a low risk investment vehicle with sufficient long-run potential to withstand short run deficits. This continued in the late 1980s in spite of evidence of softening markets because investors took the long-term view and other development opportunities were not apparent.

The relatively low land and construction costs and popularity of smaller buildings meant that the small investor could get involved with relatively small amounts of equity; the position of the small investor was further enhanced by the introduction of the \$100,000 capital gains exemption. The presence of many small investors, each acting more or less independently, kept investment at relatively high levels.

Although the Montreal rental market is subject to a form of rent control, the system is not as restrictive as in many other jurisdictions, and does not appear to impact negatively on expectations of capital appreciation.

- In **London**, the promotion of syndicated buildings as tax shelters to higher income individuals prompted much of the activity in this market; lender policies which allowed the financing of the buildings based on their values as condominiums also facilitated this investment. The perception of London as a relatively stable market and the lack of a substantial current market for condominiums to provide an alternative investment vehicle for developers also enhanced the attractiveness of rental investment both for syndication to other investors and for developers' own portfolio.

These factors appear to have been sufficiently attractive to overcome the negative influence of rent controls in the London market.

- In **Winnipeg**, government programs and the promotion of rental buildings for tax shelters encouraged much of the private rental construction. In addition, lack of competition from condominiums and abundant land kept costs low. Some developers in Winnipeg also built for their own portfolio.

The fact that new buildings are exempt from controls for five years also was a factor in the rental investment in Winnipeg.

In conclusion, there was one very important factor that was shared by all three centres with significant rental construction in recent years - the availability of **adequate supplies of pre-zoned land**. This was key in keeping costs for rental development low.

The reasons for lack of construction in Calgary and Vancouver were very different:

- In **Calgary**, the pro forma analysis indicated that the economics of rental construction in 1990 were comparable to the situation in Montreal, London and Winnipeg. However, despite the improvement in the attractiveness of rental investment brought about by increasing rents, and lower interest rates in the latter 1980s, investors were hesitant to get involved in what they perceived to be a high risk investment vehicle - they remembered what happened to real estate values when the Alberta economy crashed in the mid 1980s. It took several years of rising rents before investors started to plan new rental projects in any significant number. The increase in interest rates in 1990, however, put much of this investment on hold once again.

The analysis of rental market prospects in Calgary indicated that new rental investment appears likely when vacancy rates moderate.

- In **Vancouver**, the economics of new rental construction were very poor due to extremely high land and construction costs, as shown by the pro forma analysis. This, combined with the attraction of superior rates of return on condominium investment, made rental investment unattractive, even at the lower interest rates which existed prior to 1990.

The strong response to the B.C. Rental Supply Program, however, indicates that investors were interested in rental projects if the returns were attractive.

Although new conventional rental construction has not been an attractive investment, the rental market itself has not been dormant - many investors did enter the market through investing in non-conventional types of rental housing.

In summary then, the major differences which shaped the environment for investment in new rental construction in Vancouver (the primary focus of this study) and the three centres with significant recent rental construction are the substantially higher costs of development in Vancouver and the attractive returns available from condominium development. These two factors can be traced to the shortages of land for development due to the restrictive municipal regulatory environment in Vancouver municipalities. The lack of pre-zoned land in particular acts to restrict supply which creates shortages and higher costs.

CHAPTER 8

THE FUTURE OF THE VANCOUVER RENTAL MARKET

This chapter provides a review and analysis of the main issues in assessing the future of the Vancouver rental market. The chapter is structured around the answers to the following series of questions which were raised in the terms of reference for the study:

- Have rents increased enough to make new rental construction viable? If not, how much higher do market rents for new units have to go before economic rents are achieved?
- Has the strong market for owner-occupied condominiums bid up the price of land?
- Has the supply of suitably zoned land been a reason why rental housing is no longer being constructed? How much of a factor is the regulatory situation (zoning, density, height restrictions, NIMBY) in limiting rental housing?
- What is the effect, if any, of the practice of registering all multiple unit projects as condominiums, even those destined for the rental market?
- Has there been too much reliance on new construction to create rental units and could the role of the existing stock in creating rental units increase? How could this be achieved? Where did the rental units that were added to the stock in recent years come from? How many came from the stock that is normally owner-occupied?
- Is the environment right for the construction of rental housing? Can it be made more conducive? Is there anything that can be done to create more affordable rental housing? What level of intervention is needed?
- Finally, the main questions to be answered in the analysis:
 - Has the market failed in the rental housing sector?
 - If so, what can the government do to restore this market?

8.1 THE ANSWERS

The answers to these questions are provided below based primarily on the analysis in the preceding chapters of this report.

8.1.1 Have Rents Increased Enough To Make New Rental Construction Viable?

No. Clearly, at the costs prevailing in the market today, achievable rents on new rental buildings are well below those necessary to make an investment in a new rental project attractive. Despite the increases in rents in recent years, the construction of new rental projects has been unattractive because of the escalation in the costs of building multiple housing.

Estimates prepared for this report indicate that rents would have to increase by approximately 20 percent in order for a new rental project to cover costs at 11 percent interest rates and the costs prevailing in the market in 1990. This gap is clearly too great for rental investment to be viable even if investors are prepared to accept some negative cash flow in the first few years after the building is completed.

As discussed below, it is expected that the size of this gap will be reduced in the next few years.

8.1.2 Has The Condominium Market Bid Up The Price of Land?

Yes. The condominium boom, which was fuelled not only by owner-occupants but also by investors who planned to rent the units to tenants, led to severe competition for the limited supply of available pre-zoned land and this led to significant price increases for land for all types of multiple housing. In addition, the substantial increases in the prices of condominiums in Vancouver in recent years led developers to expect higher returns for investment in condominium development than were available from rental development.

However, this has now changed. The condominium market is oversupplied and it is clear that new developments targeted at this market will be much less attractive in the next few years than they have been in the past. This is likely to lead to significantly lower volumes of condominium development and less pressure on the available supply of land.

From the analysis undertaken for this report, it is not possible to quantify the likely impact of these changed market conditions on the prices of land and construction; however, it seems likely that prices will soften and could drop significantly. Developers with multiple land in the approvals process who planned to build new condominiums will be faced with a lower demand (and hence price) from this source and will need to look at alternatives such as rental development, holding the land and paying (non-deductible) interest costs until the market improves or selling it to someone else - who will then face the same choices.

8.1.3 Has The Supply of Suitably Zoned Land Been A Factor Behind The Low Volume of New Rental Construction?

Yes, indirectly. It is clear from the analysis in this report that despite the presence of large supplies of potential multiple land, limited supplies of multiple housing land which were pre-zoned and available for building were a major factor behind the escalation in land costs in Vancouver in recent years. The strong demand for new condominiums combined with the limited supply of pre-zoned land and a cumbersome approvals process led to escalations in the prices for multiple land which only the economics of condominium development could support. Rental housing was effectively crowded out of the market by the higher potential profits of condominium development.

8.1.4 Has The Practice Of Registering All Multiple Rental Projects As Condominiums Been Positive For New Rental Development?

Yes. Most developers across Canada register their new rental buildings as condominiums in order to provide the maximum flexibility for future sale of the buildings. Given the uncertainty of future government policies towards the rental market (e.g. the possible introduction of rent controls or restrictions on the conversion of rental buildings to condominiums), the option of converting the buildings to owner-occupancy through sale of the units at some time in the future reduces the owner's exposure to risk. This is positive for new rental investment.

The fact that there has been little new private conventional rental development in Vancouver in recent years does not negate the positive aspect of allowing developers to strata-title rental buildings as condominiums. If this were not allowed, developers would be even less inclined to invest in rental housing because of the more restricted options.

8.1.5 Has There Been Too Much Reliance On New Construction To Create New Rental Units?

Yes and No. Yes, in the sense that some observers continue to think that conventional housing is the primary source of additions to the rental housing stock. No, in terms of the actual operation of the market.

Given the volume of non-conventional units (e.g. rental houses and condominiums and secondary suites) added to the rental stock in recent years, the market is clearly not relying on new construction. It is apparent that there is a substantial capacity to create new units from within the existing, mainly owner-occupied, stock. Over the 1985-1989 period, it is estimated that roughly 25,000 units were added to the rental stock from this source. This vastly exceeds the contribution of private and public conventional rental starts, about 3,100 and 7,100 units, respectively.

To the extent that municipal regulations restrict the creation of secondary suites, it seems likely that, despite the large number of suites created in recent years, the potential supply from this source is not being fully realized.

8.1.6 Is the Environment Right for the Construction of Conventional Rental Housing?

No, not at the present time. At the costs which prevail in the Vancouver market, new rental projects do not provide an attractive return on investment - in fact, they produce substantial losses.

However, as noted earlier, this environment is changing. Among the major changes that are occurring are the following:

- **Lower real land and construction costs** - with the slowdown in the condominium market, the volume of condominium development is declining significantly. This will reduce both the pressure for ever higher prices for land and the competition for scarce construction trades. It appears that both land and construction costs are now softening and, given the increases in recent years, they could drop significantly - as they have in Toronto. In any case, it seems certain that they will decline in real terms in the next year or two - the only question is how much?
- **Lower interest rates** - with the recession in Canada, interest rates have declined and this will improve the economics of rental investment.
- **Developers seeking alternative investment vehicles** - with the attraction of the super-normal profits that were available in condominium development no longer a factor, developers with multiple land will be examining alternative forms of investment. The obvious alternative for land which is zoned for multiple housing is some form of rental development.
- **Increasing competition from rental condominiums** - a sizeable component of the demand for condominiums in Vancouver in recent years has been from individuals investing in units in condominium buildings as rental properties. The supply from this source has already resulted in an increase in rental vacancy rates in Vancouver. Further rental supply from this source is likely in the next year or so given the large number of units currently unoccupied or still under construction. As these new units are added to an already oversupplied condominium market, there will undoubtedly be an increase in the volume of condominium units for rent.

Unlike the previous three factors, which were all positive in terms of the direction of their impact on the economics of conventional rental investment, this is a negative factor in the short-run. The increase in the supply of rental condominiums will reduce the pressure for rent increases and thereby slow the pace of reduction in the gap between economic and market rents.

While positive for tenants, the oversupply of condominiums is a negative factor in terms of promoting new rental construction.

It is unlikely that the first three factors will be sufficient to stimulate the construction of new unsubsidized conventional rental housing in the short-term, given the increase in rental vacancy rates in Vancouver. The high vacancies will reduce the pressure for increased rents which is important to improve the economics of new rental construction. Also, since new rental buildings generally cater to the higher-rent end of the market, to the extent that the new vacant condominiums are also generally high-quality, high-rent units, the demand for new rental buildings will be reduced.

For the longer-term, the environment for new conventional rental investment is very difficult to predict. The reduced pressure for rent increases over the next few years is likely to delay any future bridging of the gap between economic and market rents. In any case, at the cost of building new units in Vancouver, it seems unlikely that rents could rise sufficiently to stimulate new construction for a long period into the future. The only way it seems likely that new conventional rental investment would become attractive in Vancouver is if the cost of new units could be reduced - and government action could assist in this process. As discussed in Section 8.2, the key area where government can affect the attractiveness of new rental investment is through ensuring that there is a surplus supply of pre-zoned land available for building. Such a surplus would, at a minimum, reduce future increases in the price of land when demand increases and could significantly reduce the price of land as owners seek to utilize returns from a non-productive asset.

8.1.7 Has the Market Failed in the Rental Housing Sector?

No. Not on the basis of the evidence gathered in this report. Section 2.4 of this study provided a conceptual framework for the assessment of market failure and the need for government intervention in the rental market. To summarize the discussion, rental market failure can be considered from two points of view:

- **Efficiency** - a market can be considered to have failed if:
 - the actors in the market are not responding rationally to market signals, e.g. developers are not building rental housing when market signals indicate they could earn a competitive rate of return on such housing. Such a failure could be justification for government action if such action could improve the situation.
 - government interventions have damaged the mechanisms by which the market determines price or output. Such a failure would justify action by the government to remove the intervention.
- **Social goals** - from the point of view of society's goals, a market may be efficient but may still not be achieving a desirable equilibrium:

- some people in the market cannot afford adequate accommodation on the private rental market. Clearly government action in terms of social housing or an income assistance program is required to assist these needy renters.
- broader social goals such as the provision of an "adequate" range of "affordable" housing for non-needy tenants may not be achieved. The measurement of market failure from this point of view requires value judgements about "adequate" and "affordable" which are extremely difficult to make - or to measure. In general, the conclusion of the analysis in Section 2.4 was that market failure in terms of this broad social goal would be measured in terms of whether the choice and range of market driven supply was limited, the filtering process was working and there was non-conventional supply of affordable housing such as secondary suites.

This section examines the performance of the Vancouver rental market in terms of these two views of market failure.

8.1.7.1 Rental investors reacted rationally to market signals

The lack of new conventional rental housing construction in Vancouver in recent years cannot, in itself, be considered market failure - despite the rising rents and low vacancies:

- Rents were held low in the early and mid 1980s due to high vacancies. A substantial catch-up was required to make new rental investment attractive.
- While rents rose in the late 1980s and vacancy rates were low, the costs of building new conventional rental housing escalated to an even greater extent - due to factors beyond the influence of the rental market: strong demand for a similar product (condominiums) and inadequate supplies of pre-zoned land.
- In examining the economics of rental versus condominium development, it is evident why developers of multiple housing would be much more attracted to the returns available from development and sale of condominium projects. New rental developments would have incurred substantial negative returns for several years; condominium projects were extremely profitable.
- The response to the B.C. Rental Supply Program indicates a high degree of interest in rental investment - **if the economics are attractive**. The program attracted approximately 100 applications for a total of 6,500 units; even with the subsidy, most of these projects had a negative cash flow in the early years of the investment.

There is no evidence to suggest that developers did not act rationally in their decision not to invest in new conventional rental housing. The potential returns were not attractive compared to the alternatives - developers made a rational decision.

Also, while conventional rental housing was not built in large quantities, there was a significant supply response in terms of the large numbers of additional rental units created from non-conventional sources - houses and condominiums for rent and secondary suites. Individuals perceived an opportunity to realize a long-term capital gain (with rental houses and condominiums) or to supplement their income (with a secondary suite). This non-conventional supply helped to dampen the pressure for increases in rents and the extreme shortages of rental housing.

In the view of the authors, therefore, there is little evidence to suggest that the Vancouver rental market has failed on **efficiency** grounds - actors have behaved in a rational manner in response to market signals. However, it seems clear that government intervention has contributed to a situation where the overall efficiency of the housing market has been reduced and rental investment, in particular, has been negatively affected. Two particular areas stand out:

- Municipal government actions which have restricted the supply of land available for development, and
- Municipal restrictions on the creation of secondary suites.

These will be discussed further in Section 8.2 which deals with what governments can do to facilitate the supply of rental housing.

8.1.7.2 In terms of social goals, government intervention is required

Clearly, there is a large proportion of the renter population which cannot afford adequate rental housing on the private rental market. Government intervention in the form of additional supplies of social housing or an enhanced shelter allowance program is required if these renters are to obtain adequate accommodation at a cost they can afford.

The performance of the rental market in terms of the broader social goals of providing an "adequate" range of "affordable" rental housing is less clear. Suitable definitions of these terms and measurements of their achievement are not apparent. However, the criteria established in Section 2.4 for measuring the achievement of these social goals appear to have been met:

- **The filtering process is clearly working** - the increase in the rental apartment vacancy rate in Vancouver in April, 1991, despite the lack of new rental apartment completions appears to indicate that substantial numbers of higher-income renters have vacated the older rental stock either to purchase a home of their own or to live in the increasing numbers of higher-

rent houses and condominiums available for rent. This process has left a large number of rental apartments available for occupancy by other renters.

- **Non-conventional supply is increasing** - as the discussion in Chapter 6 indicated, there has been a substantial increase in the supply of houses and condominiums for rent as well as secondary suites over the past several years. Secondary suites, in particular, are an appropriate affordable housing option for smaller households with limited means. Houses and condominiums are generally larger and command a higher rent than conventional rental accommodation; they are more appropriate for larger households.
- **No evidence of limited choice of supply** - the increase in vacancy rates in Vancouver in April, 1991 was evidence that the supply of rental housing provided an ample range of choice at that time. Supply was less abundant in the late 1980s, however, this was a time of market adjustment and the tight market had the impact of stimulating additional non-conventional supply.

While government intervention is clearly required in terms of assisting those who cannot afford adequate accommodation on the private market, there appears to be little evidence to support the need for intervention because of a lack of choice in the market. This does not mean, however, that government actions to facilitate new supply (such as pre-zoning land and legalizing secondary suites) would not enhance the operation of the market.

8.2 WHAT CAN GOVERNMENTS DO TO FACILITATE THE SUPPLY OF RENTAL HOUSING?

There are a number of areas in which action by government could facilitate new private rental supply in Vancouver. This includes actions by all levels of government since they all have an impact on the rental market. Specific actions by which governments rental housing are outlined below:

- Ensure an adequate supply of pre-zoned land;
- Facilitate the creation of secondary suites; and
- Encourage small investors.

Subsidies to encourage private rental construction are not considered to be a good means of enhancing the supply of rental housing.

Each of these is discussed in more detail below.

8.2.1 Ensure an adequate supply of pre-zoned land

The lack of an adequate supply of land pre-zoned for multiple use was identified as the single most important factor which created the shortages and spiral in the cost of multiple housing in the late 1980s in Vancouver. While there is an abundant supply of **potential** multiple land, the process of obtaining zoning is fraught with difficulties and uncertainties. In times of high demand, the process creates a shortage of land for development - which causes a bidding up of prices for land available for building.

The increased availability of land pre-zoned for multiple use is imperative to ensure an adequate supply consistent with the demand for multiple housing. There should, in fact, be an **oversupply** to allow for unanticipated increases in demand. An adequate supply is essential to avoiding the costly price spirals for land when demand increases beyond the available supply and the approvals process maintains the shortages by imposing a lengthy wait to add to the stock of appropriate land.

Municipalities (and municipal politicians) must recognize that the ultimate result of the continuation of current restrictive policies is unacceptable. Designating land for different types of uses is an important municipal function which facilitates the planning and creation of desirable communities. Pre-zoning does not imply any softening of the principles of good planning, it simply means that municipalities have a responsibility to ensure that sufficient land is properly zoned and available to meet the demand.

This requires that municipalities collectively should prepare projections of expected growth and ensure that there is adequate pre-zoned land available to meet that growth. In Ontario, for example, as a result of shortages of land in the past, municipalities are now required by the Province to prepare projections of future growth and to ensure that, at all times, there is sufficient registered or draft approved land (essentially land ready to be built upon) to accommodate **three** year's growth. Such a system requires both realistic growth projections and a land supply monitor which provides a realistic estimate of the amount of land **available** for development - these are areas where the Province and/or the federal government could assist.

Another area where the Province could assist is in ensuring that there is sufficient infrastructure to allow development which is consistent with projected growth to proceed. Financing of infrastructure is a major problem for many municipalities and may be a consideration in municipal policies which (deliberately or accidentally) restrict growth.

Because of the lack of new conventional rental construction in Vancouver, it has been suggested that zoning of land by tenure would be a good option - that would ensure that land which could be used for rental housing is not lost to condominium development. This type of initiative would attack the symptom of the problem, not the cause. As discussed in the report, the shortage of multiple land at a time of strong demand for condominiums resulted in a bidding up of land prices which

contributed to the poor economics of rental investment. The cause of the problem was the shortage of multiple land. If this can be solved, prices should be more stable in times of high demand - both for rental and condominium development. Creation of an oversupply might also result in some reduction of real land prices over time.

8.2.2 Facilitate the Creation of Secondary Suites

Legalizing secondary suites without occupancy restrictions in single-family dwellings would encourage small investors to create more secondary suites. The interest in supplying this type of housing, which is appropriate for smaller households of limited means, has been proven by its role as an important source of additional rental housing in recent years. However, though many small investors have created secondary suites, despite their illegality, it is likely that more supply would be forthcoming from this source if their existence was condoned by law. This would require the identification of practical standards for such suites as well as the need for upgrading of existing substandard secondary suites to meet acceptable standards.

An important consideration in this regard is to address the negative perceptions which many neighbours and politicians have with regard to secondary suites such as their potential negative impact on property values. An Ontario study examined this issue in detail and concluded that secondary suites had no perceptible impact on the value of neighbouring properties.⁸¹ Also, concerns about the impact of secondary suites on infrastructure are generally misinformed: to the extent that they occur most often in older existing neighbourhoods, they tend to replace population which has been lost over time due to the trend to smaller household sizes. The impact of secondary suites on infrastructure is, nonetheless, an important issue which should be addressed by municipalities before facilitating their creation in areas where infrastructure could be a problem.

Secondary suites represent an especially attractive means of creating additional rental units. They are generally located in built-up areas which have established services. They are generally small which makes them particularly suitable for the one and two-person households which are the dominant types of renter households. They are generally very inexpensive compared to newly-built housing. And they are attractive not only to tenants but to owners who frequently need the income (or, in the case of elderly or disabled owners, the company and assistance) which a renter could provide. In summary, secondary suites represent an ideal way to create affordable rental housing which should be encouraged by municipalities - not opposed.

8.2.3 Encourage Small Investors

Non-conventional housing (rental houses and condominiums and secondary suites) owned by small investors have comprised most of the additions to the rental stock in

⁸¹ Ekos Research Associates Inc., *The Impact of Conversions on Neighbourhoods: Property Values and Perceptions*, prepared for the Ontario Ministry of Housing, 1987.

Vancouver in recent years. As noted above, encouragement of secondary suites by municipalities would assist in enhancing the creation of additional rental units from this source; the oversupply in the condominium market has also increased the supply of rental housing from this non-conventional source. However, the analysis of the Montreal rental market indicated that there could be a role for the small investor in supplying new **conventional** rental housing in Vancouver as well.

The environment which exists in most Vancouver municipalities does not encourage the creation of rental housing by small investors and, indeed, may even indirectly discriminate against them. In particular, the land approvals process has become sufficiently complex that it is now professionalized and bureaucratized, and the time, cost and detail act as a particular deterrent to the small investor. In Montreal, there is an adequate supply of pre-zoned land and minimal paperwork - this encourages the participation of small investors who are not equipped (either in terms of time or resources) to deal with complex municipal procedures.

A range of initiatives that municipalities might consider to enhance the presence of the small investor in the supply of new rental housing includes:

- The creation of zoning categories and lot sizes designed to facilitate small apartment buildings and triplexes, etc.
- Allowing newly-built single-family homes which have convertible space already built or roughed-in.
- Reducing the time and complexity for approvals. This is a deterrent for all investors but is particularly difficult for small investors. Since small rental buildings, by their nature, present fewer potential problems for the municipality, a case could be made that a separate and more simple procedure might be appropriate for these buildings.
- More flexibility in the planning and building departments in terms of hours of operation (e.g. evenings and Saturdays).

These initiatives could be of significant assistance to individuals and small companies which are interested in investing in rental properties but are discouraged by the current system. The promotion of smaller developments is particularly attractive in terms of addressing the NIMBY problem - smaller buildings, by their nature, are less likely to meet with community opposition.

8.2.4 Direct Subsidies to the Needy - Not Private Rental Investment

There is a large and growing need for assistance among needy renters in Vancouver, as in most centres across Canada. There will always be some proportion of the renter population which cannot afford adequate accommodation without government assistance and governments have a responsibility to provide for this need. Current

programs are not adequately addressing this need. Whether through an increase in the provision of social housing or the expansion of the SAFER shelter allowance program, there clearly is a need to expand the assistance available to this sector of the population.

This is not the case with subsidies for private sector investment. Although the provision of rental housing might be enhanced temporarily by the provision of such subsidies, they are very costly and provide only temporary stimulation to the private sector - they do not address the underlying problem of the poor economics of rental investment. In addition, on-off government programs create a climate of uncertainty in the market and can inhibit investment in periods when subsidies are not available since investors tend either to wait for the next program or to fear competition from new (lower-rent) government subsidized projects.

The subsidies available from government for the rental market are best directed at renters who need assistance. The best way to deal with a shortage of new private rental supply is to reduce the impediments to new rental investment - as are outlined in previous parts of this chapter.